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. If you would like to discuss any of these issues, please contact us.

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In Texas, Some Rare Good News About Cities With Pension Woes

Detroit. Stockton. Puerto Rico. The list of places bankrupted by ballooning pension obligations and other debts is growing. But now comes some good news about two cities, Dallas and Houston, that have pulled back from the brink.

Just six months ago, the mayor of Dallas, Michael S. Rawlings, was warning that his city might need to declare bankruptcy after a panic led stampeding retirees to pull half a billion dollars out of its pension fund for police officers and firefighters.

But instead of going to bankruptcy court, Mr. Rawlings went to Austin, the state capital, to lobby for state pension laws that would stop the bleeding. So did the mayor of Houston, Sylvester Turner, who faced other pension problems and had persuaded the city's labor groups to agree to concessions worth $1.3 billion over the next 30 years.

Each city had its own bill, because each had its own unique problems. But both bills involve measured reductions in pension accruals for workers and retirees — mainly in secondary benefit categories like inflation adjustments and lump-sum payouts. In exchange, the pension funds will receive more money from the cities to protect the core benefits.

Most important, both bills establish financial benchmarks for the coming years. If the pension funds do not meet them, there will be more benefit cuts, some of which could be steep. The point of this is to keep elected officials from giving the can one good kick down the road now, then declaring victory and turning their backs while the same intractable problems are festering under the surface.

"The key to all this is, not one retiree's pension check is going to be reduced one penny," said Ray Hunt, the president of the Houston Police Officers Union. "It just means that future increases are slowed or stopped. I believe the majority of our members think this is the responsible way."

As happy as the resolution may seem, the steps that Texas took are illegal in other places where public pensions are imperiling the finances of cities and states. Illinois, California, Oregon, Pennsylvania and Kansas are among the states where, by law, public pensions cannot be reduced — not even the pensions that current workers hope to earn in the future.

That doctrine, known as the California Rule, explains why California cities like Vallejo and Stockton reduced their payments to other creditors when they went into bankruptcy but did not touch their workers' costly pension plans.

Of all labor groups in the public sector, police and firefighters' unions tend to be the California Rule's most ardent champions. When Memphis recently tried to scale back pensions, for example, half the police force called in sick and hundreds of others resigned.

Police unions in California are now pushing a critical test of the California Rule through the courts, after a lower court ruled that they did not have "an immutable entitlement" to the best pension they could hope for, but "only to a 'reasonable' pension." Final adjudication appears to be many months away.

Against that forbidding backdrop, Dallas and Houston show there is still room for compromise (although Houston's firefighters did withdraw their support for the bill that was just signed into law).

Both cities were spurred to act by the risk of credit downgrades and by a recent accounting change that calls for cities to calculate the number of years before their pension funds will run out of money — a once-unthinkable catastrophe that has come to pass in Prichard, Ala.; Central Falls, R.I.; and now Puerto Rico.

Those developments — and Detroit's bankruptcy — have shown that Washington will not bail out government pension funds that go bust; officials had to patch together money from other sources, and even then, the retirees of Prichard, Central Falls and Detroit had their benefits cut. Cuts are expected soon in Puerto Rico, too.

Seeing that, and knowing that the doomsday clock was also ticking in Dallas and Houston, made labor leaders in those cities conclude that fighting concessions to the finish would not, in the end, protect their members. The Dallas pension fund was on track to run out of money in 10 years, and Houston's in less than 15.

And in both cities, the police and firefighters have opted out of Social Security, something state and local workers often do in hopes of avoiding the Social Security payroll tax. Federal law allows that, but if a government pension fund collapses, older adults are left without a backstop.

"We have to have a fair pension system, both for us and for taxpayers," said Mr. Hunt of the Houston police union. "It's either that or take a 100 percent pension cut in the future, when you have no pension fund."

Josh McGee, the chairman of the Texas Pension Review Board, a state oversight body, called Houston's overhaul "one of the most comprehensive I've seen in the country," and all the more notable because the mayor who pushed it through is a labor-friendly Democrat.

As for the Dallas pension measure, Mr. McGee called it a good first step.
"Dallas waited until they were in crisis before they did anything, so it's really, really painful, and it's going to take more actions in the future to solve the problem," he said.

Dallas's measure includes raising the retirement age, slowing benefit accruals, ending most cost-of-living increases and raising each worker's required pension contribution to 13.5 percent of pay, from 8.5 percent.

Importantly, the new law for Dallas also bans the kind of big, one-time withdrawals that caused last year's run, in which retirement-age police and firefighters stripped about $500 million out of their pension fund, leaving it tattered almost beyond repair.
Such lump-sum withdrawals were allowed under a fairly common program known as a DROP, for deferred retirement option program, but they caused a stampede after workers learned that the pension fund had been overstating its assets.

The workers started to grab cash for fear that it would not be there later if they waited. Hundreds of people qualified for payments over $1 million each, in addition to their regular pensions.

The changes approved Wednesday are not expected to turn the fund around, only to stabilize it. The law calls for Dallas to stress-test the fund in seven years and to make more cuts if it fails. City officials have warned that they may still claw back some of the money people took during last year's run.

On Thursday, Fitch, the credit-rating agency, said it would review Dallas's rating. The city had been on a watch list for likely downgrades because of pension risks.
Houston had different pension troubles, dating to 2001, when officials decided that the bull market of the 1990s justified big benefit increases. The dot-com crash quickly showed that the decision was a mistake, but instead of revoking the increase, the city coped by not making its yearly contributions to the fund.

"The city was on a path to bankruptcy, and we just realized we were going to have to have some kind of reform," said Mark Watts, the head of the Greater Houston Partnership's municipal finance task force.

Under the new law, Houston reduces certain secondary pension benefits, like a DROP feature and cost-of-living increases, in exchange for better funding.

If costs still keep rising too sharply, the law calls for further reductions. And if that does not work, the system automatically shuts down the defined-benefit plan and switches to a hybrid, called a cash-balance plan.

"That caps the city's downside risk," said Mr. McGee, of the Texas Pension Review Board.

4 Reasons Why Puerto Rico's 'Bankruptcy' Process Matters to U.S. Residents

How Puerto Rico grapples with its staggering debt is in the hands of a federal judge who will oversee a form of bankruptcy proceeding for the U.S. territory. Puerto Rico owes more than $74 billion dollars to both island and U.S. based creditors and over $40 billion in pension liabilities.

But Puerto Rico's financial straits are far from limited to those living on the island. The process will have far-reaching impacts across the continental U.S.; here are four reasons why.

Retirees across the United States are at risk of being drastically affected

Since Puerto Rico's bonds have been tax exempt since 1917, U.S. investors and mutual funds have flocked to them through the years, and are now at risk of losing billions of dollars.

Here's an example of how mainland U.S. residents are affected: More than 40 percent of the Rochester Maryland Municipal Bond Fund and the Rochester Virginia Municipal Fund are invested in Puerto Rican bonds. Funds from Oppenheimer Funds and Franklin Templeton are heavily invested in Puerto Rico. If these funds collapse, public sector retirees and employees from states that invested in them will suffer. It's expected that there will be plenty of litigation among the bondholders, as each jockey for position to collect payment.

A default would have far reaching impacts across the U.S. bond markets

Some of the investment companies that have a significant stake in Puerto Rico could perhaps collapse if they are not repaid, and potentially trigger a situation like last decade's subprime mortgage crisis. Consequently, the companies with the highest levels of exposure to risk are expected to litigate vigorously.

One of these companies is Ambac Assurance, which insures up to $11 billion in Puerto Rican bonds and owns approximately $268 million in island bonds. Ambac filed a motion on May 17 opposing Judge Swain's decision to consolidate for administrative purposes the Title III requests filed by the Oversight Board, arguing that any consolidation will reduce their chances for recovery. On June 1st, District Judge Laura Taylor Swain granted a motion filed by Puerto Rico's Oversight Board and issued an order stating that these cases would be consolidated for procedural purposes only.

A large number of Puerto Rican residents have been moving to the U.S.

Puerto Rico has been under an economic recession for over 10 years, which has prompted more than 10 percent of its residents to move to the U.S. It's expected the island's recession will continue, given that the Board's fiscal plan expects to shrink the island's economy, at least for the next 2 years. This will most likely result in more Puerto Ricans continuing to migrate to the continental U.S.

There are now over 1 million Puerto Ricans living in the state of Florida alone, and it is almost certain that Florida and other states will see many more residents from the island arriving to their jurisdictions in search of work and a fresh start.

Court process sets precedent for other U.S. jurisdictions in financial turmoil.

The U.S. Virgin Islands, another U.S. territory with just over 100,000 residents, is under a $2 billion debt. Consequently, they will be watching how Puerto Rico's court process unfolds to determine if it is in their interests to seek Congressional protection. Furthermore, states with high debt or pension obligations might look to Puerto Rico's Title III process to see if they can eventually have a similar remedy made available to them.

How Title III Under Puerto Rico's Fiscal Control Board Works

May 17 was a historic day for both Puerto Rico and the United States, as the U.S. District Court there held its first hearing on the island's bankruptcy, thus officially starting the first case under the Puerto Rico Oversight, Management and Economic Stability Act, more commonly known as PROMESA, enacted by Congress in 2016.

This law created a process combining elements of traditional Chapter 9 and 11 bankruptcies that will permit U.S. owned territories to adjust their debts. Previously, U.S. law did not give territories the remedy used by state municipalities such as Detroit to restructure their debts.

Puerto Rico, an island obtained by the United States after the 1898 Spanish American War, is the first territory to use this process, expected to have far reaching implications not only for the island and its inhabitants, but also across the U.S. financial markets and pension systems.
This process is regulated in Title III of PROMESA, and it's presided by New York district judge Laura Taylor Swain. She was appointed to the case by Supreme Court Chief Justice John Roberts, who, under PROMESA, is the person authorized to select the Judge.

The Title III process differs from a traditional bankruptcy case in several aspects. PROMESA establishes that a 7-person Oversight Board, whose members were recommended by Congress and officially selected by President Obama in 2016, will act as the island’s representative.

However, this does not mean that the Board is required to act in the island’s best interests, as PROMESA does not impose any fiduciary duties to it. It mainly requires the Board to develop a plan that helps Puerto Rico achieve fiscal responsibility and eventually regain access to capital markets.

Furthermore, PROMESA gave the Board’s members immunity for all actions they carry under the Act, and they can override Puerto Rico’s laws and elected officials.

Under Title III, the Board will work with Puerto Rico’s creditors to renegotiate the island’s debts. Once this is done, they will present a Debt Adjustment Plan to the court for approval. This Plan will be approved if it complies with the requirements set in Section 314 of PROMESA.

One requirement of note is the one in Section 314(b)(6), which establishes that the plan will be approved if it “is feasible and in the best interests of creditors, which shall require the court to consider whether available remedies under the non-bankruptcy laws and constitution of the territory would result in a greater recovery for the creditors than is provided by such plan.”

This section is likely to give Judge Taylor Swain more power over Puerto Rico than she would have in a traditional Chapter 9 bankruptcy process, under which a similar plan would be approved if it “is in the best interests of creditors and is feasible”. It is unknown why this additional requirement was added to Title III.

In order to protect the best interests of the creditors, the Court is authorized to allow the Oversight Board to interfere with Puerto Rico’s political or governmental powers and alter its properties, revenues or the use of its income producing properties.
This Section gives powers to the Board that are unique in U.S. law, as, they appear to give it the ability to, for example, potentially dispose of Puerto Rico’s assets and properties and have a say in the way the island government provides basic services to its 3.5 million residents, even though it

was not elected to do so by the Puerto Rican people. Judge Swain seemed to be aware of this power during the hearing, when she remarked that this case must lead to a “better future” for Puerto Rico.

Bigger than Detroit and Argentina?

Judge Swain scheduled hearings through December. In addition, the Judge issued an order yesterday requiring Puerto Rico to file a Creditor Matrix by June 30, 2017, and to file a list of all its creditors by August 30, 2017.

However, this process is expected to last several years and become the largest municipal bankruptcy in U.S. history, easily surpassing Detroit’s $20 billion dollar default, and perhaps come close to matching Argentina’s historic 2001 default of over $150 billion dollars.

Who will pay for this bankruptcy process estimated to cost tens of millions of dollars? It will come out of Puerto Rico's pockets, in a process that will fundamentally transform the future of the island, its obligations towards its residents and its relationship to the United States.

In sum, Puerto Rico finds itself in uncharted legal waters. As this case unfolds, it will be important to see how Judge Swain and the Board protect the island’s residents and ensure that Puerto Rico can develop a sustainable economic plan to transform and grow its economy without jeopardizing its residents.

Furthermore, it will be essential that Judge Swain orders a full audit of the debt as part of this process, so there can be a clear understanding of which individuals, elected officials and businesses were responsible for this financial catastrophe so they can be held accountable.
Finally, in order to protect the best interests of both Puerto Rico’s and US residents, it's vital that this process and the audit of the debt moves authorities to enact legal reforms that end any unscrupulous, unethical or illegal financial practices that led to this tragic situation.

Ohio Public Pensions Suffer Cuts

Public-employee pension funds are big business in Ohio, providing a safety net for 1.75 million people.
There's a lot riding on them.
Collectively, Ohio's five public pension funds have $192 billion in assets and last year paid out more than $15 billion in pension benefits and $1.1 billion in health-care benefits. They are not required by law to provide health insurance, but all five do. Whether they will in the future is uncertain.

Although the funds have been mostly reliable and financially sound for decades, recent economic downturns, soaring health-care and prescription-drug costs, and the increased longevity of retirees have taken a toll. Several of the funds are reducing or eliminating cost-of-living adjustments, cutting subsidies and increasing health-care premiums.

The five funds are the Ohio Public Employees Retirement System (public workers); State Teachers Retirement System (teachers); School Employees Retirement System (school-bus drivers, cafeteria workers, janitors, secretaries); Ohio Police & Fire Pension Fund (municipal police officers and firefighters); and the Highway Patrol Retirement System (state troopers).

The Ohio General Assembly has oversight of all five through the Ohio Retirement Study Council.

The big question: How long can the pension funds hold out financially in this economic climate? A study released in December by the Mercatus Center at George Mason University painted a gloomy picture.

"Ohio's four largest public pension plans are severely underfunded based on traditional metrics of pension solvency, and they are only guaranteed to be able to finance their promised obligations for roughly the next decade without additional taxpayer contributions," economists Erick Elder and David Mitchell wrote.

"However, the funding ratio does not take into consideration the investment risk associated with pension-plan assets; even if Ohio's pensions were fully funded today, they would still only have a fifty-fifty chance of being able to fulfill their promises in the year 2045."

The School Employees Retirement System

Members of this pension fund are the lowest-paid of the five, averaging about $24,000 a year, and the fund is under fire from members and the Ohio Association of Public School Employees, a labor union, because of proposed changes in cost-of-living adjustments.

Retirees receive a 3 percent COLA one year after retirement, but fund administrators propose eliminating the COLA from 2018 to 2020 and then capping it at 2.5 percent thereafter. Retirees would get no COLA until their fourth anniversary.
About 200 union members marched last week from the Statehouse to the fund headquarters at 300 E. Broad St. in protest. Some said they are worried that the proposed COLA changes signal bigger problems.

"The fear people have is not having a pension," said OAPSE President JoAnn Johntony, 76, head custodian in the Girard City Schools in Trumbull County, where she has worked for 50 years. "To try to solve these problems on the backs of school employees is wrong.

"We have to live and pay bills like everybody else," Johntony said. 'They're not seeing the human side of this. They're not seeing how this affects our daily lives."

Lois Carson, 57, the union's vice president and a secretary in the Columbus school district, said she will live on her late husband's small pension and her pension when she retires.

"I will probably be moving in with my kids to survive," she said. "I've very scared about it."
Facing increases in health-care costs, SERS retirees will be making less in retirement benefits than they did 30 years ago, Carson said.

The fund must get legislative approval for the COLA changes. Bills are pending in both the Ohio House and Senate. Administrators say the changes are needed to stabilize the fund and continue to provide health-care benefits that otherwise probably would run out in less than a decade.

The Ohio Retirement Study Council recommended last week that the legislature approve the COLA adjustment for the school-employees fund.

Ohio Public Employees Retirement System

With 1 million active members and retirees, this is the largest public pension fund in Ohio and the 12th-largest public retirement system in the nation. It affects about 1 in 12 Ohioans and has 3,680 public employers in the system.

Changes began in 2012 when the General Assembly approved increasing employee contributions, raising retirement ages and allowing COLA adjustments.

OPERS spokesman Todd Hutchins said the changes keep the health-care package intact "for the foreseeable future." Hutchins said the fund is 85 percent funded for the future, falling within the 30-year requirement under state law for paying off pension liabilities.

Some of the changes, however, will make it harder for younger retirees and spouses of retirees. New retirees will pay about $219.33 in monthly health premiums, more than six times what retires paid last year. The fund is also ending both premium payments and reimbursement of some Medicare expenses for the spouses of members.

Ohio Police & Fire Pension Fund

The fund provides pension, disability and optional health-care benefits to full-time police officers and firefighters and their dependents.

"We continue to meet the state requirements as far as our funding level. That's something we have to look at every year," spokesman David Graham said. "We must be able to pay off our unfunded liabilities in a 30-year period, and we're at 29 years."

But changes are coming for fund members as trustees begin the process of providing stipends to retirees to seek their own health-care coverage rather than providing health insurance for them.

John Gallagher, the fund's executive director, told The Dispatch, "Our investment returns in 2016 were excellent, with a net 10.9 percent return for the year. Our current challenge is finding a way to sustain a health-care option for our retired population. While it is not a requirement that we provide a health-care plan, we realize it is a vital part of a secure retirement."

State Teachers Retirement System

Like other public employees, retired teachers face big changes in their benefits. As of July 1, the system will temporarily eliminate all new cost-of-living increases in pensions to "preserve the fiscal integrity of the system." Spokesman Nick Treneff said the situation will be re-evaluated in five years.

The system previously reduced the annual increase to 2 percent from 3 percent.
Treneff said the decision to eliminate the COLA resulted from three factors: lower-than-expected returns on investments, a larger-than-expected payout in pension benefits, and new mortality statistics showing that retirees are living longer, thus increasing the fund's financial liability.

"Health care isn't a requirement, but we know members value it," Treneff said "To have good coverage is essential to the life of retirees. We don't divert any money to health care from employee contributions."

Ohio Highway Patrol Retirement Fund

With 3,200 members, the fund is by far the smallest pension system, and it has had to increase health-care premiums annually to remain in the black.

Like the other funds, the patrol system is struggling to meeting costs, said Mark Atkeson, the executive director. "Health-care costs have skyrocketed. The collapse of 2008-2009 set everything back, and we're not completely recovered from that."

Last week, the retirement study council approved removing a provision allowing patrol members to retire at age 48 with unreduced benefits; it also approved some reductions in off-duty disability and survivor benefits. The changes need the approval of the legislature.

Although those adjustments will help, the system's health-care fund is projected to run out of money in less than a decade, Atkeson said.

Pennsylvania governor signs pension reform bill

Pennsylvania Gov. Tom Wolf signed a state pension reform bill into law Monday that will change retirement benefits for most state employees and all school employees hired after Jan. 1, 2019.

At the signing, Mr. Wolf said that Senate Bill 1 "reduces Wall Street fees" and "shifts unnecessary risk away from the taxpayer." He added that the new law "could save … over $10 billion to Pennsylvanian taxpayers."

"Let's be clear: This plan addresses our liability in the only real and responsible way possible, by changing the structure of pension benefits," said Mr. Wolf. "The fact is, we cannot accelerate the shrinking of our liability on the backs of our current employees, and this bill recognizes this in a real, concrete way."

Senate Bill 1 moves new workers not in high-risk jobs such as state police and corrections officers into a hybrid retirement system, receiving half of their benefits from the current taxpayer-funded plan and half from a 401(a) defined contribution plan.

New employees hired after Jan. 1, 2019, can elect to solely participate in the 401(a) plan. Current employees also will have 90 days to choose to opt into the new hybrid plan in 2019.
The law will affect the $51.3 billion Pennsylvania Public School Employees' Retirement System and $26 billion Pennsylvania State Employees' Retirement System, both based in Harrisburg.

The law is projected to save more than $5 billion and shield taxpayers from $20 billion or more in additional liabilities if state investments fail to meet projections, said a news release issued from the office of Republican Sen. Jake Corman, the bill's chief sponsor.

The Senate passed the bill on June 5. The House of Representatives passed it on June 8.

California's boldest pension reform: five years in

If you don't give city employees a pension, what happens?

San Diegans voted five years ago this month to switch all new city hires, except police, from pensions to 401(k)-style individual investment plans, becoming one of the first big cities to take the plunge.

Jacksonville, Fla., took a bigger step last April, switching all new employees including police and firefighters to 401(k)-style plans. Last week, Pennsylvania's governor signed legislation switching new state employees and teachers to three 401(k)-based options.

The Michigan legislature approved legislation last week that puts new teachers in a 401(k)-style plan unless they opt for a "hybrid" pension-401(k) plan. Michigan was the first to switch state employees to 401(k)-style plans two decades ago, followed later by Alaska and Oklahoma.

As one of the city forerunners of what public pension advocates hope does not become a trend, San Diego will be watched. The 401(k)-style plan is the radical reform, avoiding all pension debt for new hires, unlike milder California reforms that curb future pension costs.

Gov. Brown's pension reform five years ago, requiring new hires to work longer to earn full pensions and making other modest changes, covers CalPERS, CalSTRS, and 20 county systems — not UC and a half dozen big cities with their own pension systems, like San Diego.

A key part of a reform approved by San Jose voters five years ago, cutting the cost of pensions earned by current workers, was blocked by a court. As the police force decreased, a plan preserving some savings was negotiated with unions and approved by voters last fall.

While the number of private-sector pensions, usually offered only by large companies, continues to drop one of the issues is whether the switch to 401(k) plans, originally designed to supplement pensions, will provide an adequate retirement.

An additional issue for local governments that switch is a job market where government pensions are standard. Remaining competitive, particularly for police, is the reason San Bernardino and Stockton did not try to cut pension debt while in banrkuptcy.

So, how's San Diego doing five years into the switch?

Little information was readily available last week from the office of Mayor Kevin Faulconer, a signer of the ballot argument for Proposition B, or former Councilman Carl DeMaio, an author of the measure, or the San Diego City Employees Retirement System.

A union official said offering new hires a 401(k)-style plan rather than a pension is having an impact on recruitment, particularly for middle and upper management and skilled positions such as engineering and surveying.

Michael Zucchet, San Diego Municipal Employees Association general manager, said the switch reduces services by contributing to an overall vacancy rate in city positions of about 10 percent, rising to 15 to 20 percent in some positions.

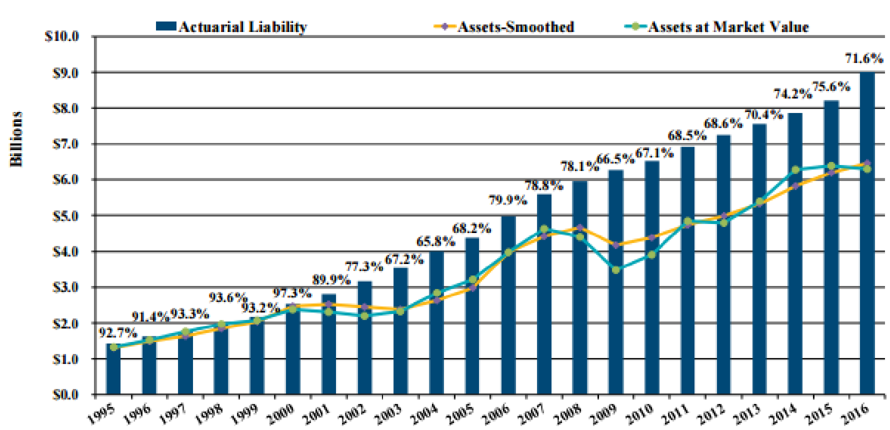
He cited the example of a staffing crisis for city 911 dispatchers on emergency calls. A survey found the total compensation of San Diego dispatchers was 30 percent below the regional average, resulting last June in a 26.6 percent pay raise over three years.

Firefighter positions (represented by a different union) still attract many applicants, said Zucchet. But a high failure rate raises questions about quality, and a loss of new firefighter suggests the city is a “training grounds” for other fire departments.

For persons pursuing a career in public service, said Zucchet, pensions are offered by San Diego County, 17 cities in the county that contract with the California Public Employees Retirement System, and other government agencies throughout the region.

“Because of that, to be perfectly frank, you would have to be sort of crazy to choose the city of San Diego,” Zucchet said. “There must be reasons other than compensation and benefits to choose here, and that’s still being felt.”

SDCERS-City of San Diego Assets and Liabilities 1995-2016



One of the twists in the San Diego reform is that the city’s independent budget analyst said in the ballot pamphlet that switching to a 401(k)-style plan is not projected to save money over the next 30 years.

Savings from ending pensions for new hires, except police, would be offset by the cost of the new 401(k)-style plan that allows a maximum city contribution of 9.2 percent of pay for most employees, 11 percent for safety employees. City employees do not receive Social Security.

But the analyst projected potential Proposition B savings of $963 million over 30 years from a freeze on pay counted toward pensions until June 20, 2018. Salaries could be increased during the freeze, but the increase would not count toward pensions.

Zucchet said because the freeze on pensionable pay was “locked in four or five years ago, the pension system was able to change its projections, and there was a realized long-term savings.”

About $200 million is expected to be saved over 15 years by increased early payments of the debt for closing pension plans, a government accounting requirement said the latest actuarial report.

Proposition B was said to be needed to curb a projected $100 million increase in city pension costs during the next decade. Zucchet said costs had already been cut by steps such as an agreement in 2009 to give many employees a much lower pension.

San Diego was fertile ground for radical pension reform because two city deals that cut payments into the pension fund while increasing pension benefits resulted in soaring debt, budget cuts, a federal bond probe, lawsuits, and national notoriety.

Now the annual city payment to the pension system is scheduled to jump to $324.5 million in July, up from $261.1 million this fiscal year. The actuarial report said the increase is mainly due to a new estimate that retirees will live longer.

Longevity also is the primary reason the pension funding level dropped to 71.6 percent as of last June 30, down from 75.6 percent the previous year. The pension debt or unfunded liability jumped from $2 billion to $2.56 billion, largely for the same reason.

The actuarial report shows a very high weighted total city contribution rate, 88.7 percent of pay. The pension contribution exceeds pay in three plans: “police old” 114.5 percent of pay, “fire old” 122.6 percent, and “elected” 153.2 percent.

A San Diego County Taxpayers Educational Foundation report in March said the current fiscal year city pension contribution was 10.94 percent of the operating budget, amounting to $233 per capita. The foundation is planning a new study on Proposition B.

There is still a chance that Proposition B may be repealed. An appellate court overturned a state labor board ruling that Proposition B was invalid because city officials did not bargain the issue with unions.

Last month, unions asked the state Supreme Court to review the appellate ruling. If the initiative is overturned, the city may face the cost of giving retroactive pensions to more than 3,000 employees that now have a 401(k)-style plan.

Private Sector

Fitch: Pension Impact Adjusted in U.S. Public Finance Criteria

Fitch Ratings-New York-31 May 2017: Under Fitch Ratings' updated U.S. public finance tax-supported rating criteria, released today, pension liabilities will be discounted at a fixed 6% investment-return assumption, with the upward liability adjustment determined by newly-reported sensitivity data. The accompanying report discusses the criteria changes related to pension analysis, and the rationale behind them in more detail.

The investment-return assumption had previously been set at 7%.

Pension liabilities and the cost of supporting them remain a source of uncertainty for governments given the generally irrevocable nature of vested benefits, the variable nature of liabilities, and the rising burden of contributions relative to resources.

"U.S. growth has been slower and more incremental over the current economic expansion than over longer time horizons. There is little evidence to suggest the economy will accelerate to previous levels of growth in the near term. Fitch believes that pensions will be hard-pressed to achieve their long-term growth expectations in the current economic context," said Douglas Offerman, Senior Director.

"The 6% return assumption, and increased total pension liability, better reflect the magnitude of the burden posed by pensions."

In another change announced in the new criteria, Fitch will compare its existing metric for the carrying cost of long-term liabilities, which relies on the reported actuarially determined contribution for pensions, to a new, supplemental metric that combines a hypothetical annual pension cost using a level repayment of the Fitch-adjusted net pension liability in a manner similar to bonded debt and an estimate of the cost of newly-accrued benefits.

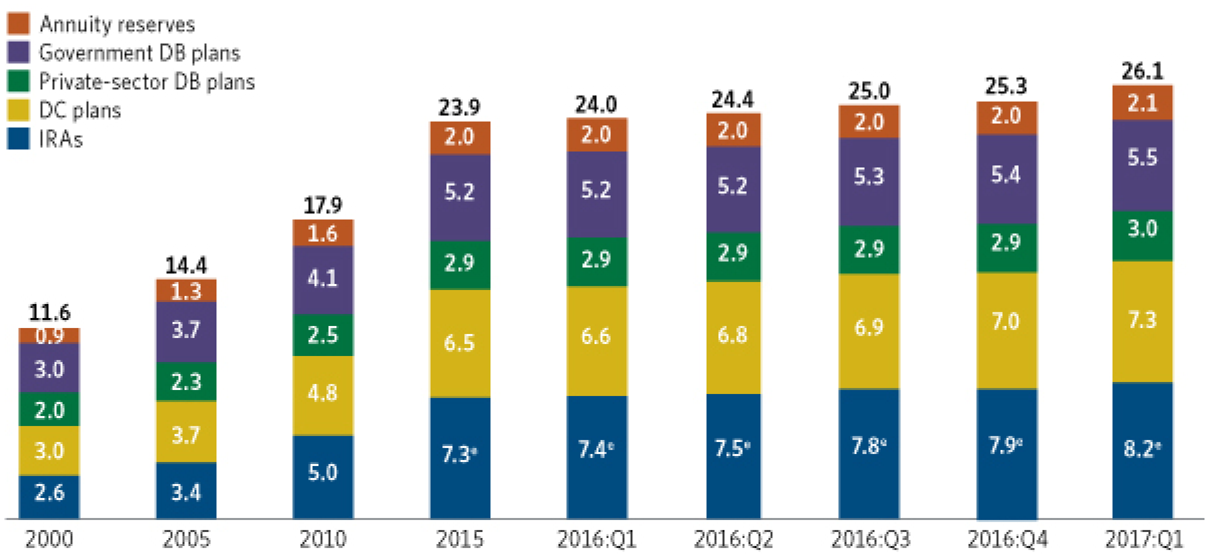
The supplemental metric highlights outliers where expenditure flexibility can be expected to decrease substantially and unavoidably over time as a result of pensions.

The criteria adjustments will have only limited impact on current ratings because existing through-the-cycle assessments already capture Fitch's expectation for rising pension burdens.

The criteria report released today updates and replaces the tax-supported rating criteria dated April 18, 2016. The only material changes to those criteria relate to the analysis of defined benefit pension liabilities. Other revisions to the report are designed to improve clarity but are not substantive changes to the rating approach for U.S. state and local government credits.

Retirement Assets Total $26.1 Trillion in First Quarter 2017

Total US retirement assets were $26.1 trillion as of March 31, 2017, up 3.2 percent from December 31, 2016. Retirement assets accounted for 34 percent of all household financial assets in the United States at the end of March 2017.



[e] Data are estimated.

Note: For definitions of plan categories, see Table 1 in "The US Retirement Market, First Quarter 2017." Components may not add to the total because of rounding.

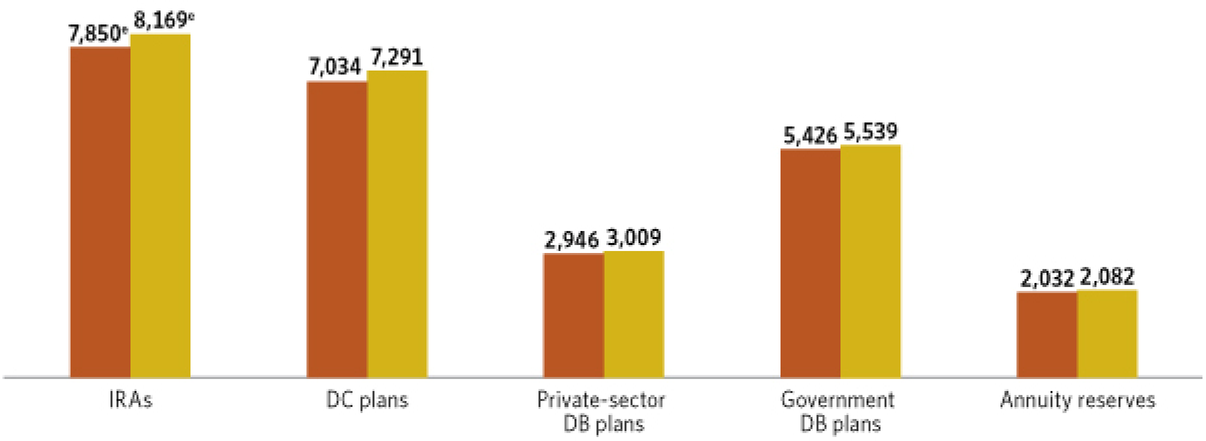
Sources: Investment Company Institute, Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

Assets in individual retirement accounts (IRAs) totaled $8.2 trillion at the end of the first quarter of 2017, an increase of 4.1 percent from the end of the fourth quarter of 2016. Defined contribution (DC) plan assets were $7.3 trillion at the end of the first quarter, up 3.7 percent from year-end 2016. Government defined benefit (DB) plans— including federal, state, and local government plans—held $5.5 trillion in assets as of the end of March, a 2.1 percent increase from the end of December. Private-sector DB plans held $3.0 trillion in assets at the end of the first quarter of 2017, and annuity reserves outside of retirement accounts accounted for another $2.1 trillion.

Retirement Assets by Type

Billions of dollars, end-of-period, 2016:Q4–2017:Q1

2016:Q4
2017:Q1



e Data are estimated.

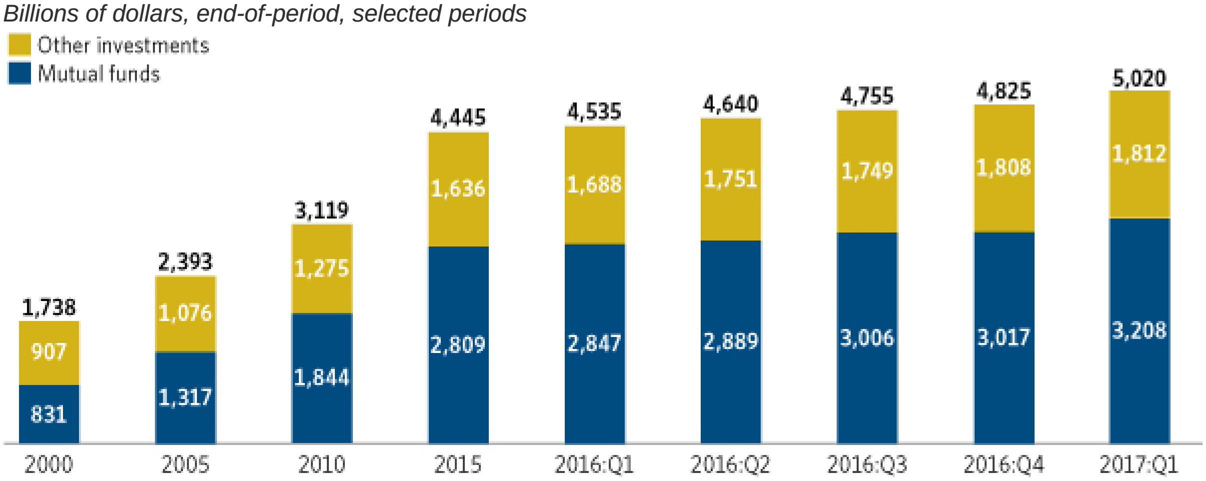
Sources: Investment Company Institute and Federal Reserve Board

Defined Contribution Plans

Americans held $7.3 trillion in all employer-based DC retirement plans on March 31, 2017, of which $5.0 trillion was held in 401(k) plans. In addition to 401(k) plans, at the end of the first quarter, $565 billion was held in other private-sector DC plans, $932 billion in 403(b) plans, $290 billion in 457 plans, and $484 billion in the Federal Employees Retirement System's Thrift Savings Plan (TSP). Mutual funds managed $3.2 trillion, or 64 percent, of assets held in 401(k) plans at the end of March 2017. With $1.9 trillion, equity funds were the most common type of funds held in 401(k) plans, followed by $890 billion in hybrid funds, which include target date funds.

401(k) Plan Assets

Billions of dollars, end-of-period, selected periods



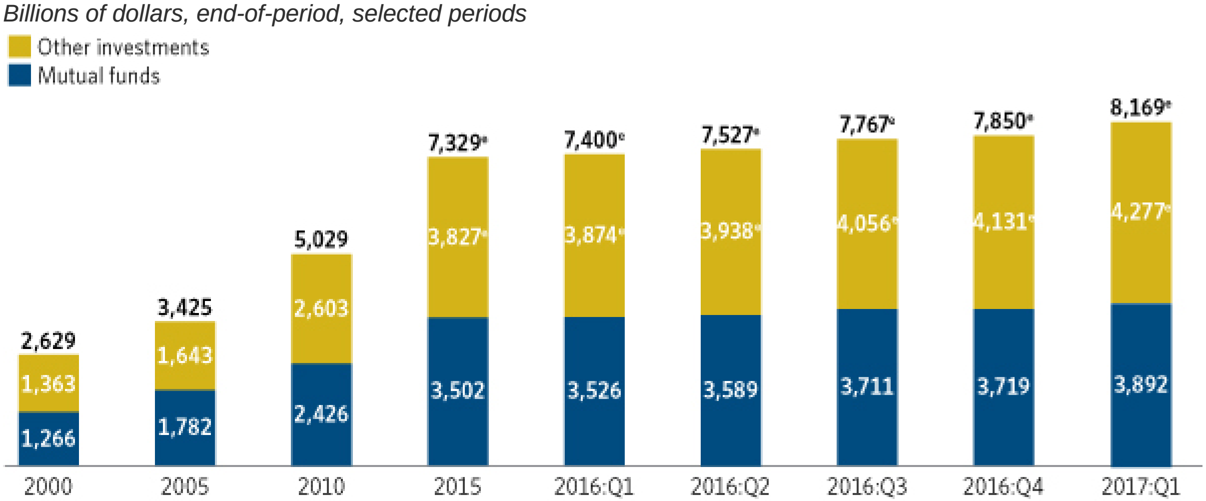
Sources: Investment Company Institute, Federal Reserve Board, and Department of Labor

Individual Retirement Accounts

IRAs held $8.2 trillion in assets at the end of the first quarter of 2017. Forty-eight percent of IRA assets, or $3.9 trillion, was invested in mutual funds. With $2.1 trillion, equity funds were the most common type of funds held in IRAs, followed by $865 billion in hybrid funds.

IRA Market Assets

Billions of dollars, end-of-period, selected periods



[e] Data are estimated.

Sources: Investment Company Institute, Federal Reserve Board, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

Other Developments

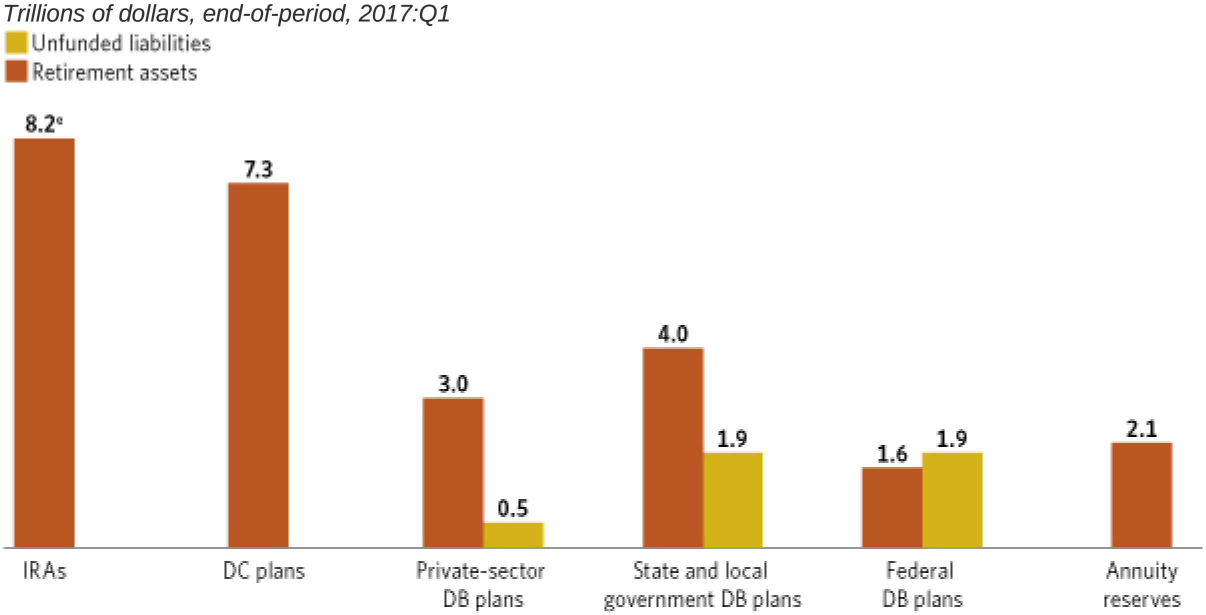
Retirement entitlements include both retirement assets and the unfunded liabilities of DB plans. Under a DB plan, employees accrue benefits to which they are legally entitled and which represent assets to US households and liabilities to plans. To the extent that pension plan assets are insufficient to cover accrued benefit entitlements, a DB pension plan has a claim on the plan sponsor.

As of March 31, 2017, US total retirement entitlements were $30.3 trillion, including $26.1 trillion of retirement assets and another $4.2 trillion of unfunded liabilities. Including both retirement assets and unfunded liabilities, retirement entitlements accounted for 39 percent of the financial assets of all US households at the end of March.

Unfunded liabilities are a larger issue for government DB plans than for private-sector DB plans. As of the end of the first quarter of 2017, unfunded liabilities were 13 percent of private-sector DB plan entitlements, 32 percent of state and local government DB plan entitlements, and 54 percent of federal DB plan entitlements.

US Total Retirement Entitlements

Trillions of dollars, end-of-period, 2017:Q1



[e] Data are estimated.

Note: Components may not add to the total because of rounding.

Source: Investment Company Institute

Thought Mortality Was Dead? Considerations for Pensions Given the IRS's Delay in Implementing RP-2014

Longevity risk, the risk that plan participants live longer than assumed, gained widespread attention in October 2014 when the Society of Actuaries released its draft of updated mortality assumptions (called RP-2014). Because this was the first update to the standard assumptions in over a decade, the change from the previous tables was noticeable: a boost of life expectancy of two to three years, on average. By 2016, accounting auditors largely required defined benefit plan sponsors to use the updated assumptions on their financial statements, resulting in an average drop in reported funded status of 4%–8%. 1

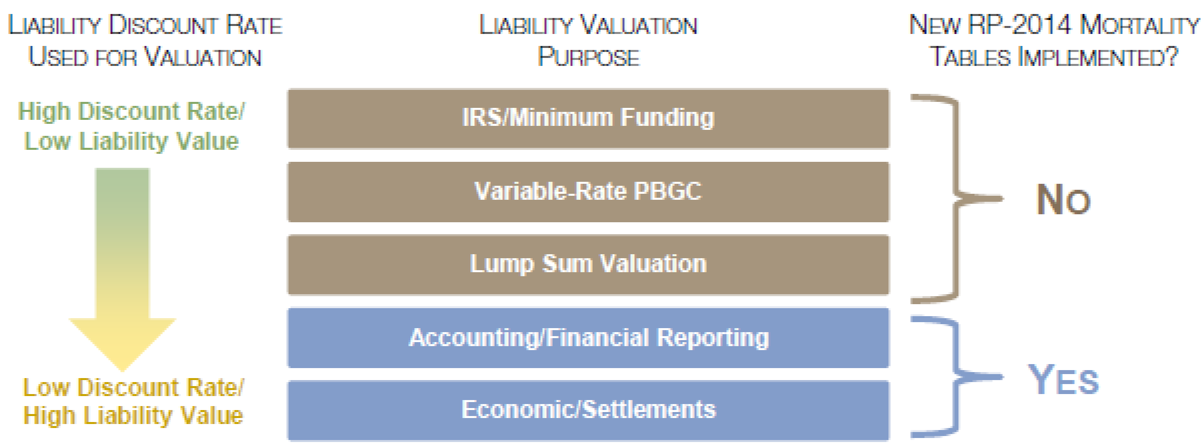
Although many sponsors likely thought they had laid the mortality issue to rest, the IRS somewhat unexpectedly decided to delay implementation of the RP-2014 mortality tables until 2018. This decision affected liability valuation for three purposes that are at least partially prescribed by IRS guidance: minimum required contributions, variable-rate Pension Benefit Guaranty Corporation (PBGC) premiums, and lump-sum distributions to terminated vested participants. Practically speaking, this means that for the remainder of 2017, the liability valuation for these three purposes is temporarily lower (and funded status therefore temporarily higher) than it will be once the new tables are adopted. While both the ultimate impact and optimal reaction to this IRS implementation delay will vary widely for individual sponsors (because of different demographics, plan provisions, etc.), this brief discusses what has changed and provides general considerations for all sponsors to weigh in the near term.

Even if no change to investment strategy is warranted, one lesson that all sponsors can glean from this experience is the importance of understanding that the rules for valuing pension liabilities (and therefore funded status) can be dramatically different for different purposes. For this reason, sponsors should ensure that they are equipped with a comprehensive pension strategy that encompasses both funding and investment policies, and that also integrates consideration of potential de-risking options.

What Has (And Has Not) Changed?

That we are discussing the impact of the new mortality tables at all may rightfully give many sponsors a sense of déjà vu. This is because in two areas, financial reporting and determination of economic valuation, sponsors have already seen the higher liability value (and thus lower funded status) as a result of the implementation of the RP-2014 mortality tables. 2 As shown below, the pension liability must be valued for many different purposes, each of which has distinct rules that govern the discount rate and, for now, required mortality assumption. Because of the IRS's recent decision to delay implementation of the new RP-2014 tables, the corresponding declines in funded status have not yet been seen in three other areas: calculating minimum contribution requirements, determining variable-rate PBGC premiums, and valuing lump-sum distributions to be paid out to terminated vested participants. We discuss considerations for sponsors related to each of these three purposes below.

Summary of Discount Rates and RP-2014 Adoption for Various Liability Valuation Purposes



Impact Considerations

Calculation of Minimum Contribution Requirements. The funded status used to determine minimum required contributions (which we refer to as "IRS funded status" for simplicity) is based on a complex set of rules first laid out in the Pension Protection Act of 2006 and amended via the Moving Ahead for Progress in the 21st Century Act (MAP–21), the Highway and Transportation Funding Act of 2014 (HATFA–2014), and the Bipartisan Budget Act of 2015 (BBA–15). Generally, a plan's IRS funded status under these rules is significantly higher than for accounting or economic purposes due to the use of a higher liability discount rate (which makes the liability value much smaller). For example, the effective discount rate allowed under BBA–15 is between 5.5% and 6.5%, while the current discount rate for accounting purposes is approximately 4%. 3 This is why sponsors' funded status for IRS funding purposes can be, for example, 110% while the PBO/accounting funded status can simultaneously be approximately 80%.

Sponsors should expect to see their IRS funded status decline next year by roughly the same amount as they saw their accounting funded status decline when RP-2014 was first used on their financial statements. In the near term, this may not have a material impact on their minimum required contributions (as shortfall contributions are amortized over seven years). However,

sponsors whose IRS funded status is just above the key threshold levels of 80% or 60% should examine whether the mortality table implementation would cause a breach of these levels, resulting in additional restrictions on the plan. These sponsors may consider making a near-term contribution to avoid the regulatory consequences.
Variable-Rate PBGC Premiums. One ongoing expense sponsors face is required premium payments to the PBGC, a government agency designed to provide a backstop to failing pension plans. 4 Each year, in addition to a fixed per-participant premium, sponsors must pay a variable-rate premium if they are not fully funded ($34 per $1,000 of underfunding in 2017, using a liability discount rate that is significantly lower than the one used for minimum contribution purposes). Over the past few years, dramatic increases to these annual PBGC premiums have been tucked into the laws mentioned in the previous section. Now, with variable rates set to jump another 20% over the next two years, premiums by 2019 will be more than quadruple what they were in 2012.

Thus, sponsors can expect a double whammy in 2018 related to variable-rate premiums: higher rates per $1,000 of underfunding from previous legislation and higher levels of underfunding due to the IRS adopting the new mortality tables. These increases in PBGC premiums and uncertainty related to mortality assumptions are two reasons that many sponsors have been taking a closer look at potential de-risking options, including lump-sum offers to certain participants.

Lump-Sum Valuations. Some pension plans allow the option to offer one-time lump sums to participants who have separated from the company but are entitled to benefits in retirement, instead of paying them an ongoing benefit until death. Two possible benefits of offering lump sums include mitigating longevity risk and reducing plan costs, including fixed-rate (and possibly variable-rate) PBGC premiums. 5 Lump-sum valuations are based on a similar discount rate to that used for variable-rate premiums and are also subject to the IRS-prescribed mortality assumption.

Therefore, for sponsors that were already considering offering lump sums to their terminated vested participants over the next few years, the remainder of 2017 offers a rare window in which, all else being equal, the value of the lump sum required to be paid will be lower than in 2018, when the IRS is expected to adopt the RP-2014 mortality tables. Unfortunately, deciding whether accelerating the timing of planned lump sums to take advantage of this—or even choosing whether to offer them at all—is very complex.

Among many other considerations, we are quick to point out three facts related to lump sums. First, from a purely mathematical standpoint, paying out benefits (and particularly large lump sums) while the plan is underfunded results in a lower funded status in percentage terms. 6 This will likely have knock-on effects for future contribution requirements and possibly create restrictions on the plan’s ability to pay lump sums in the future. Second, with a lower asset base, it becomes more difficult to close the funding deficit through asset returns (as opposed to sponsor contributions). Finally, the profile of the liabilities “left behind” after removing terminated vested participants is different, both in duration and the uncertainty of their value—there are simply more assumptions required to value the liability for an active participant than for a terminated vested participant (e.g., compensation increases, expected tenure, and, of course, the rate of life expectancy increases over time).

Is a Change in Investment Policy Warranted?

Most plans will likely not require a dramatic shift in investment policy as a result of the IRS delaying the implementation of the RP-2014 mortality tables. Nonetheless, sponsors may find assessing the impacts on their individual plans to be a valuable process. As may be clear given the discussion of the many disparate rules governing liability valuation for different purposes, sponsors should craft an overall pension strategy that both incorporates and prioritizes the objectives most relevant to them, subject to their unique constraints and risk tolerance. For example, the CFO of a publicly traded corporate plan may care a great deal about the volatility of financial statement impacts, while a non-profit CFO may care more about the timing and volatility of required contributions or the impact on debt covenants. Different strategies and considerations may be appropriate in either case.

We have long advocated a holistic approach to pension risk management that encapsulates sponsor-specific objectives and risk tolerance with respect to funding policy, investment policy, and the possible use of de-risking levers (e.g., lump sums, pension risk transfers). Adopting this approach can allow sponsors to be proactive in determining the strategic response most in line with their specific goals and constraints when regulations or assumptions (like mortality) change—particularly when these changes have different impacts on IRS, accounting, and economic liability valuation. This will continue to be important because, even after the IRS adopts the RP-2014 tables, the issue of mortality will not die. While large changes in baseline mortality assumptions (like those from RP-2014) do not occur frequently, smaller tweaks (e.g., to the rate at which mortality improves over time) are made on an annual basis. However, as the recent IRS decision shows, the magnitude and timing of these annual impacts are not always perfectly in sync for IRS and accounting purposes. Sponsors who align their funding and investment objectives as regulations, assumptions, and markets change are thus best positioned to efficiently achieve their objectives.

As a first step toward an integrated pension strategy, sponsors should ensure that all relevant internal stakeholders (e.g., CEO, CFO, Treasurer, HR) understand the various ways in which the pension plan impacts the organization and have a basic understanding that the funded status calculated for one purpose (e.g., minimum required contributions) can be dramatically different than that for another purpose (e.g., arranging pension risk transfers to an insurance company). Additionally, ensuring coordination between all external service providers—including the plan actuary, accounting auditor, and investment advisor—will help ensure that the strategy is being executed properly.

The Bottom Line

The IRS's somewhat unexpected decision to delay implementation of the RP-2014 mortality tables has impacted at least three separate aspects of pension plan strategy. This highlights the need for sponsors to appreciate the sometimes widely divergent assumptions used in calculating funded status for different purposes. Formulating a holistic pension strategy that appropriately balances sometimes conflicting objectives—and ensuring coordinated execution—is pivotal to creating long-lived success.

Justices side with religious hospitals in pension dispute

Religious hospitals don't have to comply with federal laws protecting pension plans, a unanimous Supreme Court ruled Monday in a case that affects retirement benefits for roughly a million workers nationwide.

The justices sided with three church-affiliated nonprofit hospital systems being sued for underfunding their employee pension plans.

The hospitals — two with Catholic affiliation and one with Lutheran ties — had argued that their pensions are "church plans" that are exempt from the law and have been treated as such for decades by federal officials.

Workers asserted that Congress never meant to exempt massive hospital systems that employ tens of thousands of workers. They said the hospitals are dodging legal safeguards that could jeopardize their benefits.

Pension plans are required to be fully funded and insured under federal law, but Congress carved out narrow exemptions for churches and other religious organizations. The hospitals claimed the law also exempts plans associated with or controlled by a church, whether or not it was created by a church in the first place.

Writing for the court, Justice Elena Kagan said a pension plan operated by a religiously affiliated hospital is exempt from the law "regardless of who established it."

The federal government has long agreed with the hospitals' understanding of the law. Agencies including the IRS and the Labor Department have assured them for more than 30 years that they are exempt from traditional pension rules.

But three federal appeals courts had ruled against the hospitals —Illinois-based Advocate Health Care Network, California-based Dignity Health and New Jersey-based Saint Peter's Healthcare System. The hospitals appealed, warning that the rulings could expose them to billions of dollars in liability.

Together, the three hospitals employ about 100,000 workers. But about a million workers around the country work for similar nonprofits that have been exempt from pension funding requirements.

In one of the cases, workers allege that Dignity Health — the fifth-largest provider of health care in the country — has underfunded its pension plan by $1.2 billion.

Justice Neil Gorsuch did not participate in the ruling, which was argued before he joined the court.

Teamsters to Propose Fix for Pensions, but Will It Work?

The International Brotherhood of Teamsters thinks it has a way to fix the troubled state of pension plans for unionized workers. The union has been circulating a draft proposal for input from policy makers, but so far the proposal isn't getting rave reviews.

Two years in the making, the draft proposal from the Teamsters is the latest attempt to prevent as many as 130 union-negotiated multiemployer plans from going insolvent in the next 20 years. More than 3.5 million workers participate in these plans.

The proposal calls for Congress to create a nonprofit private-sector corporation tasked primarily with making loans to poorly funded plans or to employers that participate in such plans. Money for the loans would come from bond purchases by investors. Payments on the bonds would be guaranteed by the full faith and credit of the U.S. Treasury.

The Teamsters proposal calls for taxpayer support for multiemployer plans and "that's something a Republican Congress and administration won't even consider," Joshua Gotbaum, guest scholar at the Brookings Institution in Washington, told Bloomberg BNA May 26. He previously was the director of the Pension Benefit Guaranty Corporation. The proposal is "complicated and the draft lacks full details, but it looks like a government bailout that isn't being acknowledged as a bailout," Jeremy Gold, a retired pension actuary and economist in New York, told Bloomberg BNA May 26.

This proposal is dealing with an unsolvable problem, since there aren't sufficient resources to satisfy the promises made to plan members who worked many years to earn their pensions, Gold said. The best and cheapest economic solution is for Congress to decide how much it wants to pay to cover payments owed to retirees and to do so, he said. Gold's 2005 paper in the Journal of Portfolio Management on transitioning to a secure pension system is listed in the draft as one of several that inspired the Teamsters' proposal.

The Teamsters are more optimistic about the prospects for their proposal.
"We are in communication with representatives on both sides of the aisle who have indicated they would support the legislation after reviewing it in its final form," Teamsters Vice-President John Murphy told Bloomberg BNA May 25.

Loan Payments Guaranteed

Under the draft proposal, obtained by Bloomberg BNA, Congress would create the Pension Rehabilitation Corp., which would make loans to companies and financially troubled pension plans for the purpose of funding pension plan deficits. These bonds would pay an interest rate determined by a qualified financial institution based on the credit worthiness of the borrower taking into account that their payment would be backed by the U.S. Treasury, Murphy said.

Once an underfunded plan that is in serious financial trouble receives a loan, its retiree liabilities would be completely accounted for by the fund's liability-matching investment strategy or by the purchase of an annuity from an insurance company. In the case of an annuity purchase, the insurer would take responsibility for paying the plan's pension obligations based on those liabilities. The plan would maintain responsibility for new retirees and continue to receive employer contributions and to invest plan assets. The plan would make interest payments on the loan for 29 years. In year 30, the plan would make one final interest payment and be required to pay the full principal amount of the loan in a single balloon payment.

Although the Treasury would appoint the PRC's chief executive officer, the new corporation wouldn't be controlled by the government and would be separate from the PBGC. It would include a 13-member "diverse stakeholder" board of directors that would include the Treasury secretary and the head of the Small Business Administration. If introduced in Congress, it would join the Keep Our Pension Promises Act, sponsored in the Senate by Bernie Sanders (I-Vt.) and in the House by Marcy Kaptur (R-Ohio), as a possible replacement to the Multiemployer Pension Reform Act of 2014. The MPRA, also known as the Kline-Miller Act, was designed to solve the crisis for multiemployer plans and the financially troubled PBGC. The MPRA has been seen as a failure by some as it was unable to provide a solution to the Teamsters' 400,000-member Central States, Southeast and Southwest Areas Pension Fund, which is projected to be insolvent by 2025.