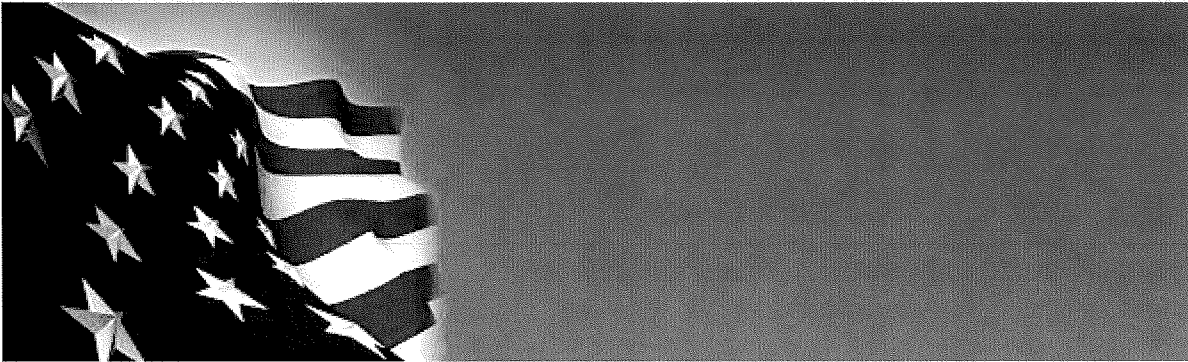


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CYPEN & CYPEN NEWSLETTER for MAY 1, 2014

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 1, 2011

1. STATE, LOCAL PENSION PLANS ECLIPSE \$3 TRILLION MARK: State and local defined benefit pension plans held \$3.05 trillion in assets in fiscal year 2012, according to pionline.com. State plans held \$2.53 trillion and locally administered plans held the remaining \$521 billion in assets, including cash and investments. Corporate stocks made up the largest asset class, with \$1.1 trillion, followed by international securities (\$534 billion), real estate holdings and trusts (\$492 billion) and domestic governmental securities (\$314 billion). Corporate bonds accounted for \$393 billion. Earnings on investments came to \$95 billion in 2012. (Note that private equity, venture capital and leverage buyouts are now classified under corporate stocks.) Out of \$144.6 billion in contributions made to the 4,000 public pension funds in the survey, employees contributed 30%, while local governments contributed 40% and state governments contributed 30%.

2. CORPORATE PENSION FUNDING STATUS SOARS: The average funding ratio for the 100 largest U.S. corporate defined benefit plans jumped to 93.5% in 2013 -- more than 10 percentage points higher than the previous two years and the highest since 2007, according to pionline.com. The funding level was 108.6% in 2007, but plunged to 79.1% in 2008, the peak of the financial crisis. In 2012, funding was 80.6%, a slight decrease from 2011's 81.6%. The aggregate funding deficit of the largest 100 plans shrank to \$122.3 billion in 2013, from a deficit of \$301.6 billion in 2012. By the way, average expected rate of return on plan assets decreased to 7.55% in 2013, down from 7.73% in 2012 and 7.94% the year before.

3. EFFECTS OF PENSION PLAN CHANGES ON RETIREMENT SECURITY: A new report from the Center for State & Local Government Excellence and the National Association of State Retirement Administrators gauges effects of changes in state pension plans on the retirement income of retirees. The following are some key findings:

- Pension reforms reduced the amount of retirement income new employees can expect to receive compared with that of existing employees. Reductions ranged from less than 1% to 20%.
- New employees can expect to work longer and save more to reach the benefit level of previously hired employees.
- Hybrid plans adopted in five states produce a wide range of estimated retirement incomes. Holding investment returns constant, the determining factor in the size of the hybrid benefit is employee and employer contributions. For this analysis, those states with higher required contributions produce a higher benefit than those whose statutory contribution rates are lower.
- Changes in retirement plans include an increase in the number of years included in the final average salary calculation (21 states); reduction in the multiplier (12 states); and a change to both of these variables (nine states).

Reasons for the recent wave of state pension reforms are numerous, and usually are unique to each state, its finances, and its workforce. In most cases, the primary objectives have been to reduce costs of providing retirement benefits and to transfer a greater portion of the associated risks from employers to employees. The study does not

address the rationale for modifications, but instead analyzes the effects of resulting changes at the individual employee level by (1) measuring how recent reforms affect the retirement income that will be provided to state employees who are hired under new benefit conditions; and (2) looking at human resource measures states have taken to directly or indirectly to address the impacts of pension reform.

4. IN FLORIDA, “WE HAVE A BUDGET PROBLEM, NOT A PENSION PROBLEM”: That quote comes from the Florida Public Pension Trustees Association, which shows how Florida builds budget problems one tax break at a time. The following factoids will demonstrate:

- 94.24% of Florida businesses paid *no* taxes in 2011.
- Florida has the 10th lowest business tax rate in the U.S., but among the highest unemployment and foreclosure rates.
- Florida offered 7 “mega-deal” business tax breaks since 2006 at a total cost of \$1.34 billion.
- Florida gives \$3.98 billion in business tax breaks every year.
- Business tax breaks equal 16 cents of every budget dollar.
- Corporate taxes contribute less than 3% to the state budget.

Any questions?

5. UPDATE ON DEFINED CONTRIBUTIONS PLANS IN THE PUBLIC SECTOR: The Center for State & Local Government Excellence has issued an update to its report on Defined Contribution Plans in Public Sector. The financial crisis and its aftermath generated two types of responses from sponsors of state and local governments. The first was to cut back on existing defined benefit plan commitments by raising employee contributions, reducing benefits for new employees and, in some cases, suspending the cost-of-living adjustments for existing retirees. The second response was to initiate proposals to shift some or all of the pension system from a defined benefit to a defined contribution plan. The brief describes this flurry of defined contribution activity, identifies the factors that led to the changes occurring in the states where they did, and presents data on participation and assets to put the flurry into perspective. The data show that, while the introduction of defined contribution plans by some states has received considerable attention, activity to date has been modest. Most state and local workers are covered by a traditional

defined benefit plan. In addition, these workers often have a supplementary 457 defined contribution plan that allows them to put aside a portion of their pay on a tax deferred basis. The brief does not address these supplementary plans, but, rather focuses on changes at the primary plan level. Before the financial crisis, a number of states had introduced a defined contribution plan to their structure. Most of these plans took the form of an optional defined contribution plan. That is, the sponsor retained its defined benefit plan and simply offered employees the alternative of participating in a defined contribution plan instead. Only two states, Michigan and Alaska, introduced plans that require all new hires to participate solely in a defined contribution plan. The Alaska reform applied to both general state and local workers and teachers, while the Michigan reform was limited to general state workers. Three states -- California, Indiana, and Oregon -- adopted hybrid plans, where employees are required to participate in both a defined benefit and a defined contribution plan. The timeline of the introduction of these defined contribution plans is interesting; much of the activity occurred in the wake of the fantastic performance of the stock market during the 1990s. After the financial crisis, sponsors have once again shown interest in defined contribution plans. This second wave of initiatives is quite different from the pre-crisis changes. First, all the new plans are mandatory, as opposed to mainly voluntary in the pre-crisis period. Second, being mandatory, they apply only to new employees. Third, none of the sponsors has followed the earlier Alaska-Michigan model of forcing employees to rely solely on a defined contribution plan where the employee bears all the risks. Rather, the post-crisis plans consist of either a hybrid plan or a cash balance plan, which is a defined benefit plan that maintains notional individual accounts but provides some guaranteed base return. Since the financial crisis, six states have replaced their traditional defined benefit plan with a mandatory hybrid plan: Georgia, Michigan, Rhode Island, Utah, Tennessee and Virginia. Three states have recently passed legislation to introduce cash balance plans: Kansas, Kentucky and Louisiana. (The last was ruled unconstitutional). The report concludes that although the introduction of defined contribution plans by some states has received a lot of press attention, activity to date has been modest. Moreover, most of the recent efforts have been a move to either hybrid plans, with a mandatory defined contribution and defined benefit component, or to cash balance plans, where participants are guaranteed a return

of 4-or 5 percent. Sponsors' shifts from complete reliance on traditional defined benefit plans appear to be driven by a desire to avoid future unfunded liabilities, to reduce investment and mortality risk and to provide some benefits to short tenure workers. Of course, moving away from defined benefit plans means that individuals must face the risk of poor investment returns, the risk that they might outlive their assets, and the risk that inflation will erode the value of their income in retirement -- on at least a portion of their retirement savings in hybrid plans. Participants in cash balance plans do receive a guaranteed return but, among the plans adopted to date, it is less than the typical 8% guarantee in traditional defined benefit plans. However, if some defined contribution component or cash balance arrangement enhances the likelihood of responsible funding, public sector employees may enjoy some increased security.

6. JERSEY'S PENSION OPTIONS ARE LIMITED: Governor Chris Christie is to be commended for allocating \$2.25 billion of his fiscal year 2015 budget to New Jersey's state administered pension funds. He is indeed correct that such amount, while far short of the actuarially required contribution, is large for New Jersey. However, Alicia Munnell, writing in MarketWatch, says the governor is misguided in his conclusion that further benefit cuts are the only way to handle exploding pension costs. First, the annual costs for accruing pensions are not exploding. What is exploding are the costs associated with having not funded pensions for the last 12 years. As a result, New Jersey owes \$56 billion to pay off promised benefits -- three quarters attributable to the state government and one quarter to local governments. Second, there are no feasible benefit cuts that could reduce this amount. If the state wants to confront this problem, the Governor will have to back away from his no-new-tax pledge to produce the revenues to pay the promised benefits. Before the financial crisis, benefits provided by New Jersey's three large state administered systems -- covering general employees, teachers, and police/fire -- were near the national average. After the crisis, New Jersey sharply reduced its costs for these systems. In 2010, legislation increased employee contributions from 5.5% to 6.5% of annual salary (8.5% to 10% percent for police/fire), and established an additional 1% increase to be phased in. The legislation immediately eliminated the cost-of-living adjustment for current and future retirees, roughly equivalent to a 20% benefit cut. For new hires,

benefits were further reduced. Once new hires replace current employees, the annual pension cost for general employees will be about 9% of payroll, with the employee contributing 7.5%. The cost for teachers will be about 10%, with an employee contribution of 7.5%. For police/fire, the cost will be about 20%, with an employee contribution of 10%. These provisions mean that, based on the system's assumed investment return, most employees will pay for the bulk of their own pension benefits. Well, if the cost of accruing annual benefits is not exploding, then what is the problem? The problem is that the state's unfunded liability has risen from zero in 2002 to \$56 billion in 2014. (This increase occurred despite an \$18 billion cut in the liability from eliminating the COLA.) So, how did New Jersey move from zero to \$56 billion? Part of the explanation is the financial crisis, which sharply reduced assets. But nearly half of the increase is due to the state's failing to make its required contributions. If contributions do not cover the cost of accruing benefits and the interest on the existing unfunded liability, the unfunded liability will grow. When the legislature reduced benefits in 2010, it did not immediately provide for full funding of benefits. Instead, it allowed for a seven-year ramp up. Thus, the continued growth of the unfunded liability since then should be no surprise: u-n-d-e-r-f-u-n-d-i-n-g. Further benefit cuts do not seem right on practical or policy grounds. For one thing, the only practical step to reduce unfunded liabilities -- eliminating COLAs -- has already been taken. To go further, the governor would have to cut more core benefits already earned by employees. But paying retirees and current workers, say, 70 cents on the dollar, is not realistic. Sure, in Detroit, the executive manager has proposed cuts to existing benefits, but Detroit has filed for bankruptcy, and a judge ruled that federal bankruptcy law trumped state constitutional provisions that protect pension benefits ([See C & C Newsletter Special Supplement for December 3, 2013](#)). And, of course, no state is allowed to declare bankruptcy. Thus, the remaining option, is to cut future benefits for current workers. Such cuts also may face legal hurdles. The argument against such change is that New Jersey benefits for current employees are already significantly below the national average, and employees pay most of the costs anyway. Again, while such changes would reduce the cost of accruing benefits going forward, they would not reduce today's unfunded liability by a single penny. The only real option, given the existing pressure on educational and other spending, is for Governor Christie to walk back his no-new-tax pledge so that

New Jersey can start paying its pension bills.

7. DETROIT REACHES SHORT-TERM DEAL WITH 14 UNIONS:

Detroit has reached a five year agreement with 14 of its unions, including AFSCME, the largest, in its bankruptcy case, according to governing.com. The tentative agreement covering 3,500 workers is among deals that Detroit has been able to reach in recent weeks, as progress toward completion of its historic bankruptcy reorganization case has intensified. The agreement, in principle, offers an opportunity for the unions to provide regular input and guidance to city management. The deal includes restoration of some pay for city workers who have faced wage freezes, and a 10% pay cut in recent years, although details will vary by union. Other factors in the deal include work rules concessions from the unions. Detroit's public safety unions, which have formed a coalition in negotiations with the city, are not part of the deal. The public safety unions have said they are still open to negotiations, but proposed contract terms so far have been unacceptable. The city has been offering police officers wages starting at \$14 an hour.

8. ROLLOVERS JUST GOT EASIER: Internal Revenue Service has issued ruling 2014-9. Effective immediately, the ruling permits a plan administrator for a receiving plan simply to check a recent annual report filing for the sending plan on a public data base, www.efast.dol.gov. This procedure eliminates the necessity for communication between the two plans (usually through the individual), and expedites the entire process. If it is later determined the amount rolled over was an invalid rollover contribution, the amount rolled over plus any attributable earnings must be distributed to the employee within a reasonable time after such determination.

9. COLLEGE ATHLETES: PUBLIC SECTOR UNIONS' NEWEST MEMBERS?:

It is easy to look at Shabazz Napier, senior point guard for the national champion University of Connecticut men's basketball team, and assume he has got it made. The NBA beckons, endorsement deals await and Napier's emotional celebration on the court following UConn's win over the University of Kentucky in the national championship game has made him a media favorite. So it is natural to forget that players like Napier are not actually financially secure -- yet. Governing.com reports that Napier said before the

national championship that it is hard for him to see his jersey getting sold while he struggles to find enough money to eat. There are hungry nights that Napier goes to bed starving. Soon, players like Napier may be able to organize and demand more guarantees in return for their commitment to a college. Following a ruling by a regional director of the National Labor Relations Board that Northwestern University football players receiving athletic scholarships were employees, and could organize, two states are weighing their options. (The labor board ruling only covers private schools.) In Connecticut, the state legislature is considering measures that would allow athletes at public colleges and universities to join unions. In Ohio, lawmakers are considering the opposite -- barring college athletes from collective bargaining. Since 1980, union membership has gone from about 20% of the workforce to less than 12%. Some believe the potential for college athletes to unionize presents an opportunity amid declining membership. A 2000 labor board ruling allowed graduate teaching assistants on college campuses to unionize, which spurred organization at public universities in a number of states.

10. FLORIDA DIVISION OF RETIREMENT 35TH ANNUAL POLICE OFFICERS' AND FIREFIGHTERS' PENSION TRUSTEES' SCHOOL: The 35th Annual Police Officers' and Firefighters' Pension Trustees' School will take place on May 12-14, 2014. You may access information and updates about Trustees' School, including area maps, a copy of the program when completed and links to register at the Aloft Tallahassee Downtown. Please continue to check the website for updates regarding the program at www.myflorida.com/frs/mpf. All police officer and firefighter plan participants, board of trustee members, plan sponsors and anyone interested in the administration and operation of the Chapters 175 and 185 pension plans should take advantage of this unique, insightful and informative program.

11. ADULT TRUTHS: Nothing sucks more than that moment during an argument when you realize you are wrong.

12. TODAY IN HISTORY: In 1941, General Mills introduces Cheerios.

13. KEEP THOSE CARDS AND LETTERS COMING: Several readers regularly supply us with suggestions or tips for newsletter items. Please feel free to send us or point us to matters you think would be of interest to our readers. Subject to editorial discretion, we

may print them. Rest assured that we will not publish any names as referring sources.

14. PLEASE SHARE OUR NEWSLETTER: Our newsletter readership is not limited to the number of people who choose to enter a free subscription. Many pension board administrators provide hard copies in their meeting agenda. Other administrators forward the newsletter electronically to trustees. In any event, please tell those you feel may be interested that they can subscribe to their own free copy of the newsletter at <http://www.cypen.com/subscribe.htm>.

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