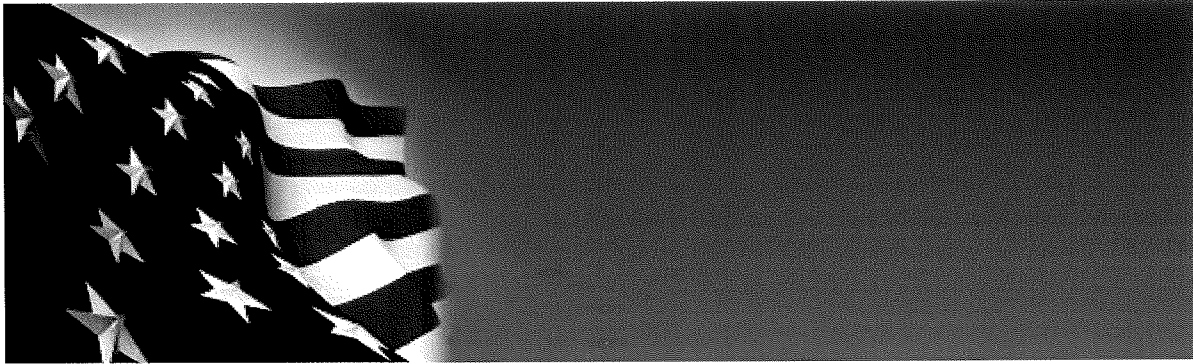


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# CYPEN & CYPEN NEWSLETTER for JANUARY 8, 2015

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

**1. PENSION PLANS DO WELL WHEN THEY ARE PROPERLY FUNDED:** Hank Kim is Executive Director of National Conference on Public Employee Retirement Systems. In the *Wall Street Journal*, Kim responded to an earlier opinion-piece that contains so many flaws and misleading arguments that even a casual reader can see it is based on the American Enterprise Institute's ideological inclination to undermine public pensions rather than on responsible research. The editorial lauds the rule "100 Minus Age" but that rule has been debunked and is considered out-of-date in academic circles and by reputable financial publications that include *Forbes*, *Money* and *Seeking Alpha*. Comparing individual investments for retirement through 401(k) style plans with group investments through pension funds is wholly inappropriate. The vast majority of American workers have little or no investment savvy -- a big minus for the effectiveness of 401(k) plans -- while pension plan investments are professionally managed and overseen by boards of trustees under jurisdiction of state and local

governments. The administrative costs of pension plans are miniscule compared to the hidden costs individuals must pay with 401(k) plan investments. Simply put, public pension plans provide a higher level of benefits at much lower cost than 401(k) plans. The truth is that the vast majority of public pensions are well funded and are growing stronger as the economy continues to recover. California Public Employees' Retirement System, for example, has higher assets today than it did in 2007, a year before the Great Recession devastated the economy and the markets. The biggest challenge public pensions face is receiving timely and full payments of annual required contributions by state and local governments. The public pension plans in trouble today are typically the plans whose legislatures have failed to fund them, even in boom economic times.

## **2. HOW DID STATE/LOCAL PLANS BECOME UNDERFUNDED?:**

Answering that rhetorical question, a brief from Center for Retirement Research at Boston College presents a new tool that describes the evolution of the unfunded liability for each of the 150 plans in the *Public Plans Database*. The period of analysis is from 2001, when most plans were fully funded, to 2013, when virtually every plan reported significant underfunding. The goal is to identify the impact on underfunding of a few well-defined factors, such as poor investment returns, inadequate contributions, and benefit changes. The discussion proceeds as follows: the first section describes the methodology and presents the results for one of the better-funded plans in the sample. The second section examines the range of experiences across plans, classified as good, average, or bad, based on funding performance. While all plans were hurt by two financial crises, bad plans also significantly undermined their financial position by failing to make adequate contributions and having to correct for overly optimistic actuarial assumptions. The final section concludes that this type of analysis presents a clean story of what happened in each plan. It reports the impact of the financial crises, but also highlights the inadequacy of plan sponsor contributions. This new tool provides a valuable way to cut through the political rhetoric and identify why a plan is in trouble. Some of the key findings are

- A new analytical tool tells a clear story of why unfunded liabilities rose during 2001–2013
- Investment returns that fell short of expectations due to the two

- financial crises.
- A second varying factor was that many plan failed to make adequate contributions, a more serious problem among the worst funded plans.
  - This type of analysis should be added to every plan's annual actuarial evaluation.

**3. RYALS RESPONDS TO EDITORIAL:** Writing in the *Sun-Sentinel*, Kimberlie Ryals, Chief Executive Officer of Florida Public Pension Trustees Association, responded to an earlier editorial. Pension reform does not have to be a zero-sum game: cut critical services or fund pensions. In fact, local governments and their employees already have resolved many funding concerns, and cut back on expenses to save taxpayers money and future risk, while still fulfilling the promise and reward of a career in public service. In a recent survey, of 36 municipal pension plans in Broward County, 25 have altered their retirement benefits, with more than half-a- dozen making as many as four or more adjustments. Several other local plans reported making such changes before 2010. Longer years of service, reduced benefits and increased employee contributions were the most common changes made to pension benefits. Fourteen plans also made structural changes like adding a second tier for new hires, and decreasing multiplier used to determine final benefits. But so-called tax watchdogs and business advocates will not stop trying to close all local municipal pension plans through a campaign of fear about supposedly catastrophic expense to taxpayers lurking over every horizon. These groups want to influence how government spends dollars at the expense of quality public services. Trustees who steward municipal public pension plans in Florida have reformed their investment funds as productive, sustainable pools that will meet the criteria of auditors and needs of future retirees. Aided by improvements in financial markets and healthy returns since 2010, pension plans continue to close gaps in unfunded liabilities. The good news for taxpayers is that pension reforms already have started saving them tens of millions of dollars.

**4. U.S. CENSUS BUREAU ISSUES QUARTERLY SUMMARY OF PUBLIC PENSIONS FOR THIRD-QUARTER OF 2014:** For the 100 largest public-employee pension systems in the country, cash and security holdings totaled \$3,305.2 billion in the third quarter of 2014,

dropping from the previous all-time-high of \$3,365.4 billion set in the second quarter of 2014, a decrease of 1.8%. Compared to the third quarter of 2013, assets for these major public pension systems increased 8.0% from \$3,061.6 billion. This decline in assets is due to negative earnings, which fell from \$129.4 billion in the second quarter of 2014 to -\$43.0 billion in the third quarter. Earnings experienced a year-to-year decrease from \$120.9 billion in the third quarter of 2013. Corporate stocks had a quarter-to-quarter decrease of 0.7%, from \$1,176 billion to \$1,168 billion in the third quarter of 2014. Corporate stocks experienced a year-to-year increase of 10.3%. Corporate stocks had a quarter-to-quarter decrease of 0.7%, from \$1,176 billion to \$1,168 billion in the third quarter of 2014. Corporate stocks experienced a year-to-year increase of 10.3% from \$1,058.7 billion in the third quarter of 2013. Corporate stocks were about one-third (35.3%) of the total cash and security holdings of major public pension systems for the current quarter. Corporate bonds had a quarter-to-quarter increase of 2.7% from \$371.5 billion to \$381.3 billion in the third quarter of 2014. Corporate bonds year-to-year increased 18.4% from \$322.1 billion in the third quarter of 2013. Corporate bonds comprised less than one-eighth (11.5%) of the total cash and security holdings of major public pension systems for the current quarter. International securities had a quarter-to-quarter decrease of 4.9% from \$656.5 billion to \$624.5 billion in the third quarter of 2014. International securities year-to-year decreased 2.1% from \$637.7 billion in the third quarter of 2013. International securities comprised about one-fifth (18.9%) of total cash and security holdings of major public pension systems for the current quarter. Federal government securities had a quarter-to-quarter increase of 0.1% from \$307.8 billion to \$308.1 billion in the third quarter of 2014. Federal government securities year-to-year increased 15.8% from \$266.1 billion in the third quarter of 2013. Federal government securities made up less than one-tenth (9.3%) of the total cash and security holdings of major public pension systems for the current quarter. Government contributions had a quarter-to-quarter increase of 4.3% from \$24.0 billion to \$25.0 billion in the third quarter of 2014, and a year-to-year increase of 12.5% from \$22.3 billion in the third quarter of 2013. Employee contributions had a quarter-to-quarter decrease of 12.8% from \$11.3 billion to \$9.8 billion in the third quarter of 2014, and a year-to-year increase of 19.0% from \$8.3 billion in the third quarter of 2013. Government contributions to employee contributions

had a 2.5 to 1 ratio this quarter-government contributions constituted 71.8% and employee contributions constituted 28.2% of total contributions. Benefit payments totaled \$62.3 billion, decreasing 2.7% from \$64.1 billion last quarter, and a year-to-year increase of 5.0% from \$59.3 billion in the third quarter of 2013.

#### **5. CINCINNATI WILL RAISE PENSION SYSTEM CONTRIBUTIONS:**

The City of Cincinnati, along with retirees and various unions representing current employees, has reached a deal fully to fund its city's pension system within 30 years. As reported by plansponsor.com, the mayor's office estimates the unfunded pension liability at \$862 million. Terms of the agreement reached include:

- \$200 million in retiree health care savings;
- Cost of living adjustment for both current retirees and active employees will go to 3% simple interest, instead of compound;
- Current employees and retirees will take a three-year COLA holiday; and
- The city will make a larger contribution to the pension annually for the next 30 years (16.25% of payroll annually).

Voters rejected an initiative in 2013 to shift new city workers to defined contribution plans. The mayor's office says the settlement provides certainty and security. The process to bring parties to this point was not easy. But this outcome will pay dividends for the city for generations to come. Good for them.

**6. MICKY ARISON FLORIDA'S RICHEST:** Wealth-X, a private wealth consultancy, has identified the richest person in each of the U.S. states, according to southflorida.citybizlist.com. Washington State tops the list with Microsoft mogul Bill Gates, now worth \$81.5 billion. Nebraska and California rounded out the top three with Warren Buffett (\$66.9 billion) and Lawrence Ellison (\$47.3 billion). Thirty-five of the 50 individuals on the list are self-made billionaires. Nine of the 50 states (Utah, New Mexico, Mississippi, Maine, Delaware, Hawaii, South Dakota, Alaska and Wyoming) do not have any billionaires. The list has six women, including Christy Walton, who, with a net worth of \$37.9 billion, is also the richest woman in the world. Micky Arison, Chairman of cruise company Carnival Corp. and owner of the NBA's Miami Heat, (at \$6.5 billion), came in at number twenty-one. (We are betting that these numbers were compiled before LeBron James left

the Heat to return to the Cleveland Cavaliers, conservatively chopping Arison's net worth by a billion dollars or so.

**7. WILL THEY TAKE THE MONEY AND WORK?:** In "Will They Take the Money and Work? An Empirical Analysis of People's Willingness to Delay Claiming Social Security Benefits for a Lump Sum," the authors investigate whether exchanging the Social Security delayed retirement credit, currently paid as an increase in lifetime annuity benefits, for a lump sum would induce later claiming and additional work. The authors show that people would voluntarily claim about half a year later if the lump sum were paid for claiming any time after the Early Retirement Age, and about two-thirds of a year later if the lump sum were paid only for those claiming after their Full Retirement Age. Overall, people will work one-third to one-half of the additional months, compared to the *status quo*. Those who would currently claim at the youngest ages are likely to be most responsive to the offer of a lump sum benefit. Here are some key findings details; using an experimental module, the authors show that

- People would voluntarily work longer if they were offered an actuarially fair lump sum instead of the delayed retirement credit under the current system, and
- People would voluntarily work between one-quarter and half of the additional time until claiming.
- The claiming delay would average half a year if the lump sum were paid for claiming later than age 62, and about two-thirds of a year if the lump sum were paid only for claiming after the Full Retirement Age.
- Individuals who respond most to lump sum incentives are those who would have claimed the earliest, under current rules.

University of Michigan Institute for Social Research, Survey Research Center WP 2014-308.

**8. AMERICA'S 401(k) GAP:** Bloomberg says the gap in the U.S. workplace between the highest and lowest paid has been growing for years. Far less noticed has been the growing gulf in retirement pay. While the very top often continue to receive executive pensions as well as other benefits, most workers are left only with their 401(k) plans. CEO compensation at large U.S. companies was 204 times higher than the pay of workers on average in 2013, up 20% since

2009. And retirement benefits divide perpetuates income inequality into old age. Some industries illustrate this trend more starkly than others. Big retailing chains, with their armies of lower-paid floor workers and their elite executive ranks, can be especially emblematic of the retirement gap. One example is Target Corp.'s executive Gregg Steinhafel, who stepped down as CEO following a massive credit card data breach, who received retirement plans worth more than \$47 million. That number is quite impressive, considering it is 1,044 times the average balance of that workers have saved in the company's 401 (k) plan. It includes \$27.7 million from a combined pension plan for top executives and a deferred compensation plan. He was also paid \$9.8 million from an earlier deferred compensation plan, as well as an additional \$9.9 million in interest payments on that sum. In addition, Steinhafel got a \$7.2 million cash severance payment and \$4.1 million from vested stock awards when he left at age 59. All of these amounts were on top of the more than \$20 million in cash salary and bonus he received over the prior five years and \$56.4 million in realized equity gains over the same period. Catch this one: Steinhafel's deferred compensation plan guaranteed 12% interest. It is good to be the king.

#### **9. PUBLIC PENSIONS WILL BE AN ISSUE IN WASHINGTON D.C.**

**THIS YEAR:** *Governing* says the booming stock market of the past few years has helped stabilize many public pension plans around the country, but 2015 will be a difficult year for states that have not been stocking their pension funds the way they are supposed to stock them. New accounting rules will cause these plans to appear significantly worse off than they were a year ago. The changes will likely spur more governments into making changes aimed at paying down their plan liabilities, particularly in states, such as Illinois and Pennsylvania, that have been slow to address the problem. In simple terms, the new rules created by the Governmental Accounting Standards Board will force two major changes. First, they will require pension plans to apply a more conservative formula in calculating actuarial value of plan assets. The new formula applies to governments that have not been making their full actuarial payments. These plans, which typically have a high unfunded liability, will now look even more unhealthy in their fiscal 2014 annual reports, which some states started releasing late last year ([See C & C Newsletter for November 26, 2014, Item 3](#)). The second big change will come up later this year, as governments begin filing their comprehensive

annual financial reports for fiscal year 2015. GASB will require governments to report unfunded pension liabilities on their balance sheets, instead of relegating them to the notes section of the report. This change will have a profound impact on a number of governments' perceived financial positions, as some plans have billions of dollars in unfunded liabilities. The impact could have serious political consequences, although it does not change the actual cost of government, someone who does not like pensions is going to look at that and say, your plan is insolvent because of this giant pension liability. The new accounting rules are unlikely to affect credit ratings, because the formal status of pension plans is not changing; what is changing is the way in which the health of these plans is reported. Thanks a lot, GASB.

**10. DO PENSIONS MATTER TO HIGH-QUALITY STATE AND LOCAL WORKERS:** Many state and local governments have responded to challenges facing their pension plans by cutting benefits. Will these cuts make it harder for state and local governments to recruit and retain high-quality workers? To date, the answer has been difficult to obtain; most micro-level datasets contain information on existence of pensions but not on pension generosity. To get around this constraint, this study from Center for Retirement Research at Boston College uses a unique source, *Public Plans Database*, to obtain data on pension generosity of state and local workers' pensions. These data are merged with the *Current Population Survey* to investigate how pension generosity affects the gap between the private sector wage of workers that states and localities recruit from the private sector relative to the workers that they lose to it. The findings suggest relatively generous pensions help reduce this "quality gap" making it easier for state and local employers to recruit high-earning workers from the private sector and retain those workers. The effect is similar regardless of whether employer or employee contributions finance the benefits. The study suggests states should be cautious as they cut their pension benefits and that a strategy to maintain benefits by shifting some costs onto employees may help maintain states' ability to recruit and retain high-quality workers. CRR WP 2015-1 (January 2015).

**11. THE COMING WAR ON PENSIONS:** *CounterPunch* says that few people realize how radical the new government's \$1.1 trillion budget

is. Budget laws are supposed to decide simply what to fund and what to cut. A budget is not supposed to make new law, or to rewrite the law. Apparently, Congress did not get the message. Wall Street's representatives in Congress, Democratic leadership as well as Republicans, took the opportunity to create an artificial crisis. The press called it "holding the government hostage." The House -- backed by the Senate -- said that it would shut the government down at some future date if two basic laws were not changed. Most of the attention has been paid to Elizabeth Warren's attack on the government's guarantee bank trades in derivatives. Taxpayer funds are put behind future bank bailouts if banks make more bad bets on complex financial derivatives, such as packaged junk mortgage loans. Critics have focused on how there must be a loser for every winner in a derivatives contract. The problem is that if the banks lose, they do not lose, the government will bail them out just as it did in 2008. Less attention has been paid to what happens if banks win. They will win largely in making bets against pension funds. Indeed, pension funds have not been treated well by Wall Street in recent years. They are in a bind. Pension funds will fall further and further behind what they need to pay retirees if they do not make the high returns of 8.5%. The guiding philosophy of pension funds has been that instead of making employers pay enough to cover the pensions they have promised, funds can make money purely financially -- by Wall Street sharpies. The problem is that safe interest rates today are less than 1% for Treasury bonds. Everything else carries some risk. And when Goldman Sachs and JP Morgan Chase draw up a derivative for a client, their aim is to make money for themselves, not for the client. So pension funds have been at the losing end. Most funds would have done better simply to turn their money over to an indexed fund, and saved management fees. At the state and local levels, pension funds in New Jersey and other states threaten to go the way of Detroit pension funds -- to be cut back so that bondholders can be paid. Many corporate pension funds also are behind, because companies are using their record profits to pay higher dividends, and to buy back their stocks to create price gains for speculators. But the funds most under attack are union pension funds, which are funds that Congress has gone after. The fight is not merely to scale back pension funds -- and avoid the government's Pension Benefit Guaranty Corporation's being bailed out -- but to break the power of unions to attract members or to defend them. The Congressional budget act states that

pension funds with more than one employer -- such as construction industry funds, teamster funds for truckers and public service workers funds -- can be scaled back in order to pay Wall Street creditors (See C & C Newsletter for December 18, 2014, Item 9). Labor now is told to go to the back of the line behind Wall Street. If the economy is too debt strapped to pay everyone what is owed, then the new motto is Big Fish Eat Little Fish. Wall Street is eating the pension funds.

**12. MINIMUM WAGE INCREASES IN 20 STATES:** Like Florida (See C & C Newsletter for January 1, 2015, Item 2), the minimum wage increased in 20 states at the beginning of this year, and later in 2015 it will go up in Alaska, New York and Delaware. As a result, *Governing* says, at least 3.1 million workers will get raises. For the first time, a majority of states, 29 plus the District of Columbia, have minimum wages above the federal minimum of \$7.25. The federal floor has not increased since July 2009, and few expect Congress to enact a hike anytime soon, although President Barack Obama has called for an increase. The average increase among the states is 50 cents an hour, but in Alaska, Minnesota, Rhode Island and South Dakota, the wage will rise by at least \$1. When the increases take effect, the average wage in the 29 states and the District of Columbia that have minimum wages above the federal floor will be \$8.42. Among all the states and the District, the average will be \$7.93. Even if there is no further action on the minimum wages in 2015, several states and the District are scheduled for increases under previously approved measures. Along with Alaska, (which will have an \$8.75 wage starting February 24), New York (which will have a \$9 minimum wage by the end of this year) and Delaware (\$8.25 by June 1), recent moves in California, the District, Michigan and Minnesota continue wage increases into 2016. By then, California could have the highest statewide wage in the country, at \$10 an hour, unless another increase elsewhere surpasses it.

**13. DILLERISMS:** Most children threaten at times to run away from home. This is the only thing that keeps some parents going. - Phyllis Diller

**14. STUFF YOU DID NOT KNOW:** The percentage of North America that is wilderness: 38%.

**15. TODAY IN HISTORY:** In 1935, Elvis Presley was born.

**16. 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.

**17. 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>.

**18. REMEMBER, YOU CAN NEVER OUTLIVE YOUR DEFINED RETIREMENT BENEFIT.**

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