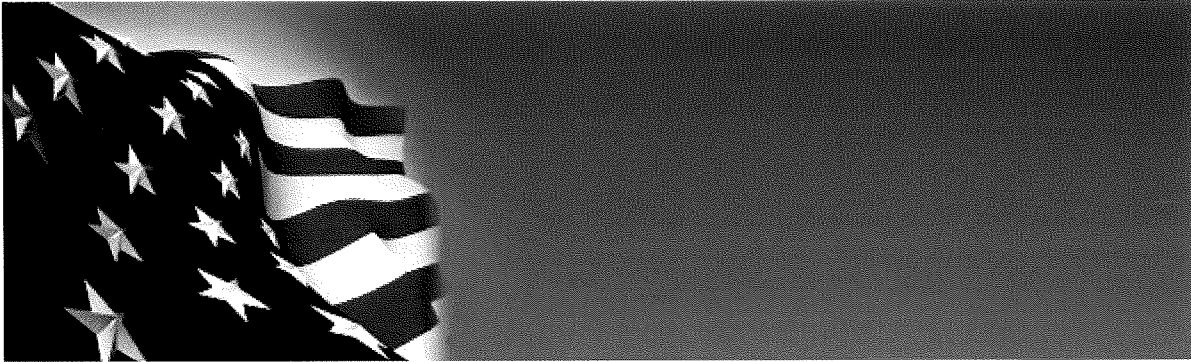


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CYPEN & CYPEN NEWSLETTER for FEBRUARY 5, 2015

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

1. FLORIDA DIVISION OF RETIREMENT “WARNS” HANDFUL OF FUNDS OF “LOW” FUNDING STATUS: Florida Department of Management Services, Division of Retirement, is responsible for reviewing Florida’s local government retirement systems for compliance with applicable laws, statutes and rules. This review consists of accessing each plan’s conformance to part VII, Chapter 112, Florida Statutes, which provides that plans are to be operated and funded in an actuarially sound manner. The Division of Retirement has written a letter to 19 (out of a total of 491) plans reminding them of something they already know: that their GASB 25 funded status is below 50%. (For those of you who do not know, GASB 25 was replaced by GASB 67 for financial statements for fiscal years beginning after, June 15, 2013.) The letter says the plans should consider taking action to prevent future taxpayers from having to incur costs, a violation of Section 112.61, Florida Statutes. That section prohibits transfer to future taxpayers of any portion of the cost

which may reasonably have been expected to be paid by current taxpayers. The letter recognizes that the plans may have been working toward or have recently implemented pension reforms, but these changes, along with positive market returns in recent years, have not had the effect of funding the expected costs of the plan. At bottom, the Division requests an immediate notification of all active and retired members of the plan regarding its conditions and what actions will be taken to improve it. The Division offers to provide any technical assistance that is necessary to address the funding status of the plan. The letter is signed by the Secretary of the Department himself. We would term this letter a call for all cities to start contributing more than just the required monies to keep the plan sound. Those days of taking funded holidays are long gone.

2. DBs NOT CAUSE OF SPONSOR FINANCIAL DISTRESS: The corporate bankruptcy narrative of ballooning pension costs driving firms to insolvency may be more myth than fact, according to a recent study reviewed in *Chief Investment Officer*. What did increase the likelihood of future balance sheet distress appeared on the defined contribution side. Plans with more than 10% of their assets in sponsor company stock had a significantly higher probability of corporate defaults than those with smaller, but still existing, exposures. These firms were also more likely to seek bankruptcy protection rather than restructure debts out of court. Finally, compounding the problem, DC plan sponsors and participants do not actively adjust these plans' exposures to company stock prior to defaults, and such inertia imposes significant losses on plan participants because of the value loss of company stock. In contrast, defined benefit pensions -- as a matter of law and practice -- rarely if ever double down on exposure to their plan sponsors by becoming long term shareholders. While both the proportion of internal stock held by DC plans and DB unfunded liabilities tended to rise as sponsors neared insolvency, the authors found no causal link between DB funding ratios and defaulting or bankruptcy. Many plans were substantially underfunded when their sponsoring firm hit the financial wall. However, those scant assets tend to be an effect of balance sheet distress rather than a cause of it. Unlike a DC plan sponsor, corporate treasuries enjoy greater leeway to fund -- or not fund -- their employee retirement pools. Still, the study determined that only 20% of bankrupt DB plan sponsors terminated their schemes by transferring the assets and liabilities (which often

end up cut down) to the Pension Benefit Guaranty Corporation. The probability of a bankruptcy filing shows no significant relationship between underfunding and the likelihood of bankruptcy. Thus, researchers concluded that their findings cast doubt on the argument that defaulting firms often opt for bankruptcies to terminate underfunded pensions, a practice not allowed in out of court restructurings.

3. TEACHERS PENSIONS CRISIS: CBS News reports that teachers pension plans across the country are staggering from a half-trillion dollars in debt. Put in perspective, that is more than \$10,000 worth of debt for every student in the nation's primary and secondary schools. In 2014, state teacher pension systems had a total of \$499 billion in unfunded liabilities, which has risen \$100 billion in just two years, according to a report from the National Council on Teacher Quality, a nonpartisan research and policy group dedicated to restructuring the teaching profession. The report card on teacher pensions found that 70 cents of every dollar contributed to state pension systems pays for this massive debt rather than covering current employees' future retirement benefits. The NCTQ collectively awarded states a "C-" for their teacher pension practices. Mississippi received the lowest grade (F) because of conditions such as long vesting periods and a poorly funded system. Only Alaska earned an "A" for its pension practices, while South Dakota received the next highest grade (B+). Reading and writing appear to be okay; arithmetic, however, not so much.

4. EMPLOYER'S POST-TERMINATION OF PLAN AMENDMENT CHANGING METHOD USED TO CALCULATE BENEFITS VIOLATED ERISA: Royal Oak challenged an Order of the Pension Benefit Guaranty Corporation. Royal Oak terminated its pension plan previously operated for benefit of its employees under the Employee Retirement Income Security Act of 1974. After the plan's termination date, Royal Oak changed the method it used to calculate certain payments to plan participants. As a result of the change, the participants received approximately \$2.1 million less than they would have been paid under terms of the plan as written on October 31, 2008, the termination date. In order to calculate the dollar value of lump sum payments, the plan administrator must find the present value of each participant's accrued benefits. That is, the administrator must use assumptions about mortality and interest rates to calculate

the value of a lump sum payment that will, in an actuarial sense, equal the value of monthly pension payments each participant is entitled to receive. The interest rate used to calculate the present value of accrued benefits is inversely related to the value of the lump sum (that is, higher interest rates yield smaller lump-sum payments). The power of compounding interest and the long term nature of pension obligations mean that even a slight change in the interest rate can have a significant impact on the size of the lump sum payments. Thus, mortality and interest rate assumptions must be specified in the plan and may not be left to the employer's discretion. Plans are not bound to adopt any particular set of actuarial assumptions. Instead, the present value of lump sums calculated according to the plan's terms shall not be less than the present value calculated by using the mortality table and interest rate specified in the Internal Revenue Code, which puts a floor, but not a ceiling, on the value of lump sum payments. If Royal Oak had simply amended the plan before October 31, 2008 (a date Royal Oak itself chose), no barrier would have been posed by the regulation, which limits only post-termination amendments. However, by waiting until after the Plan's termination date, Royal Oak took on the burden of complying with both the statute and the regulation. The Pension Protection Act of 2006 Amendment was not a valid post-termination amendment, and therefore Royal Oak must make additional payments to ensure the plan participants receive the benefits to which they are entitled under the plan's provisions in effect on the plan's termination date. Thus, Royal Oak's motion for summary judgment is denied and PBGC's motion for summary judgment is granted. *Royal Oak Enterprises, LLC v. Pension Benefit Guaranty Corporation*, Case No. 13-1040 (U.S. D.D.C. January 28, 2015).

5. AN ILLINOIS PENSION RULING MAY NOT IMPACT CHICAGO CASE...HUH?: If the Illinois Supreme Court voids Illinois's pension reform law, Reuters says that ruling will not necessarily derail another law aimed at shoring up two of Chicago's public pension funds. Both Illinois and Chicago are defending separate laws in different state courts against challenges from labor unions and retired workers that the measures, which will reduce pension benefits, are unconstitutional. A lawyer representing Chicago told a Cook County Circuit Court Associate Judge that the 2014 law for Chicago's municipal and laborers' retirement systems would not automatically be voided if the

state's high court later this year determines a 2013 law enacted for Illinois's sagging pension system is unconstitutional. He said the state is basing its defense on the need to invoke its police powers to ensure it can fund essential state services. The city has an additional argument that its law does not unconstitutionally diminish pension benefits because without its cost-saving elements and higher contributions, the two pension funds would become insolvent within a matter of years. An attorney representing a coalition of unions countered that the city was making a "flimflam argument," which is the pension fund has to be killed in order to save it. As we recall, the Illinois Constitution does not have a police power exemption to the contract clause.

6. VIDEO FOOTAGE FELL WITHIN EXEMPTION, AND THEREFORE WAS CONFIDENTIAL AND EXEMPT FROM PUBLIC INSPECTION:

LYNX appealed a declaratory judgment in favor of Post-Newsweek Stations, which held that the Public Records Act's exemptions for security systems and security system plans do not apply to LYNX buses' camera footage. LYNX argued that the plain language of statutory exemptions to the Public Records Act rendered security footage confidential and exempt from public record requests. The District Court of Appeal reversed. LYNX installed a comprehensive video-surveillance security system using, in part, money obtained from the United States Department of Homeland Security. Signs in plain view on the buses indicated the cameras' presence, and provided notice that persons may be recorded by a video surveillance system that may also include audio recording. Post-Newsweek Stations filed public records requests, seeking to inspect video footage captured by cameras on LYNX's buses. LYNX denied the requests, asserting that the videos captured by the surveillance system were confidential and exempt from public record inspection because the videos fell within the exemptions for security systems. The video footage from this surveillance system was used and accessed in joint training with local and federal law enforcement. The training focused on how to prevent, deter, and when necessary, respond to criminal and terrorist attacks in a mass-transit environment. Cameras are regularly used and accessed by law enforcement officers in real world, non-training exercises. Chapter 119, Florida Statutes, was enacted to promote public awareness and knowledge of government actions in order to ensure that

governmental officials and agencies remain accountable to the people. The Florida Public Records Act is to be liberally construed in favor of open government, but exemptions from disclosure are to be narrowly construed. The agency bears the burden of proving its right to the claimed exemption. The plain language of Section 281.301, Florida Statutes, and Section 119.07, Florida Statutes, makes confidential all records revealing a security system. The videos reveal capabilities -- and as a corollary, the vulnerabilities -- of the current system. Because the Legislature's intent is apparent from the plain language, which in this case is free from ambiguity, the Court found no need to analyze the legislative history. *Central Florida Regional Transportation Authority, d/b/a Lynx, v. Post-Newsweek Stations, Orlando, Inc., d/b/a WKMG-TV Local 6*, 40 Fla. L. Weekly D306 (Fla. 5th DCA January 30, 2015).

7. U.S. FAMILY BALANCE SHEETS IN PRECARIOUS STATE:

Strains on income expenditures, and wealth have families vulnerable to financial emergencies, according to The Pew Charitable Trusts. Even as the national economy continues to recover from the Great Recession, most U.S. families remain financially fragile. Pew's report, "The Precarious State of Family Balance Sheets," draws from multiple nationally representative data sources to develop a clear picture of household financial security in the United States. The findings in the report reveal widespread financial fragility:

- Although income and earnings have increased over the past 30 years, they have changed little in the past decade. The typical worker had wage growth of 22% between 1979 and 1999 but just 2% from 1999 to 2009.
- Substantial fluctuations in family incomes are the norm. In any given two-year period, nearly half of households experience an income gain or drop of more than 25%, a rate of volatility that has been relatively constant since 1979.
- The Great Recession eroded 20 years of consumption growth, pushing spending back to 1990 levels. As a result, the net increase in average annual household spending is just 2% since 1990.
- The majority of American households (55%) are savings-limited,

meaning they can replace less than one month of their income through liquid savings.

- Even when pooling all of its resources -- including from accounts that are potentially costly to access, such as retirement accounts and investments -- the typical middle income household can replace only about four months of lost income.
- Most families face financial strain across all balance sheet elements: income, expenditures and wealth. Fully 70% of households face at least one of these problems, with many confronting two or even all three.

The report concludes by noting that policymakers should focus on policies and programs that support asset accumulation, which can help meaningfully improve American families' financial standing.

8. PANEL SUGGESTS MILITARY RETIREMENT BENEFIT CHANGES: Plansponsor.com says the Military Compensation and Retirement Modernization Commission has issued a report of recommendations for changing retirement and health benefits for military personnel. The panel says the uniformed services retirement system should be modified to provide retirement benefits to many more service members, and maintain the value of retirement benefits for current members. It notes that 83% of personnel will not be eligible to receive the pension for which 20 years of service is required. It recommends that uniformed services implement a blended retirement system that offers both defined benefit and defined contribution elements. The panel suggests active and reserve service members should continue to vest for the DB plan after 20 qualifying years of service. However, it recommends a new calculation for benefits. DB retirement annuities would be computed as the retired pay base multiplied by 2% multiplied by years of service -- the multiplier is currently 2.5%. The panel suggests current service members should be allowed to opt in to the new blended retirement system. With the new DC plan, each service member would be enrolled automatically, with the military contributing 1% of each member's basic pay into his account and each service member deferring 3% of his basic pay into his account. The plan would include a match contribution up to 5% of basic pay. A period of two years of service should be required before a service member can vest in the matching contributions. The reason

is due to the high attrition that occurs during the first two years of service (approximately 25% for enlisted personnel and 9% for officers). The panel also suggests a new continuation pay should be authorized and paid at 12 years of service to all members who are willing and able to commit to remain in service for an additional four years. The continuation pay would equal 2.5 times service members' monthly basic pay, and it would be recommended, but not mandated, that a service member put this continuation pay into the DC plan. The combination of an adjusted DB plan, a new DC plan and continuation pay would maintain the value of retirement assets for service members who serve for at least 20 years. Service members would also be allowed to choose full or partial lump sum payments of their DB benefits, to allow them flexibility to receive retirement benefits based on their individual life circumstances. Full monthly retirement annuity payments should resume for all service members at full retirement age for Social Security benefits to ensure they have a stable, regular income during normal retirement years. For your information, the full report is almost 300-pages.

9. EBSA's FINAL REGS ON ANNUAL DB FUNDING NOTICES:

Employee Benefit Security Administration has published in the Federal Register a final rule to increase pension plan transparency by ensuring that workers receive annual notification of the funded status of their defined benefit pension plans. The final rule implements the annual funding notice requirement of Section 101(f) of the Employee Retirement Income Security Act of 1974, as amended. The final rule requires the administrators of defined benefit plans (single-employer and multiemployer) to furnish an annual funding notice to participants, beneficiaries, the Pension Benefit Guaranty Corporation and certain other persons. The rule enhances retirement security and increases pension plan transparency by ensuring that workers receive timely and accurate notification annually of the funded status of their defined benefit pension plans. The document also contains necessary conforming amendments to other regulations under ERISA, such as the summary annual report regulation. The final rule is applicable to notices for plan years beginning on or after January 1, 2015. Prior to this applicability date, however, plan administrators may elect to comply with the requirements of the final regulation and the Department of Labor, as a matter of enforcement, will consider such compliance as satisfying the requirements of section 101(f) of ERISA.

This temporary enforcement policy does not address the rights or obligations of other parties. The effective date is 30 days after of publication in the Federal Register, approximately March 4, 2015. 29 CFR Part 2520.

10. IRS FORM 1099-R UPDATED: Internal Revenue Service has updated form 1099-R for 2015. Generally, distributions from pensions, annuities, profit-sharing and retirement plans (including Section 457 State and Local Government Plans), IRAs, insurance contracts, *etc.* are reported to recipients on form 1099-R. Here are the form and instructions: <http://www.irs.gov/pub/irs-pdf/f1099r.pdf> and <http://www.irs.gov/pub/irs-pdf/i1099r.pdf>.

11. CORPORATE DB PLANS LEAD IN RETURNS: Year-end December 31, 2014, corporate defined benefit plans had a median return of 8.5%, public DB plans returned a median 6.8% and foundations/endowments returned a median 5.9%, according to pionline.com. Overall, the gains were a median 7% for the year, about half of the overall median return in 2013. In 2013, public DB plans returned a median 16.1%, foundations/endowments 15.2% and corporate DB plans 12.6%. For the fourth quarter, following a third quarter that saw slightly negative returns for all types of funds, corporate pension funds returned a median 2.4%, public pension funds 1.3%; and foundations/endowments 1%. Fourth quarter, corporate DB plans were assisted by larger allocations to domestic fixed income and domestic equity, at a median 39% and 29%, respectively, while public DB plans were also supported by a larger domestic equity allocation of 34%. Those DB plans were, however, slightly hurt by a larger median 23% allocation to international equity. Foundations/endowments, meanwhile, finished at the bottom for the quarter due in part to large median allocations to private equity and international equity at respectively, 24% and 12%.

12. CALPERS PLANS TO TRIM PE PORTFOLIO: CalPERS is pruning its private equity allocations again, according to a report from the *Financial Times*. The pension said it would be re-examining its relationships with managers, paring back to a core group and teaming up with other investors to drive down fees. CalPERS currently maintains management relationships with nearly 125 managers. The chief investment officer suggested that the final number of managers

in its private equity portfolio, could be fewer than 100. It is unclear if CalPERS plans to use the secondaries market to reposition its portfolio, and a spokesperson said CalPERS is exploring a number of options. CalPERS cut back on private equity twice last year as part of a broader effort to absorb cash from realizations and de-risk the portfolio during the prolonged public equities rally of 2014. In both of those cases, the pension said it was more or less just working to bring target allocations back in line. It reduced target allocations from 14% to 10% in May, and is also considering a change to how it benchmarks overall private equity performance. The move comes after the pension pulled out of hedge funds entirely for similar reasons – complexity and fees. CalPERS has taken on a more conservative investment approach.

13. DILLERISMS: His finest hour lasted a minute and a half. Phyllis Diller

14. YOU KNOW YOU ARE LIVING IN 2015 when...: Your reason for not staying in touch with friends and family is that they do not have e-mail addresses.

15. TODAY IN HISTORY: In 1967, “Smothers Brothers Comedy Hour” premieres on CBS (later ABC, NBC).

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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