

FEATURE STORY - October, 2005



Seeking Solvency

As defined-benefits wells run dry and cash-balance uncertainties abound, opinions are mixed about what might salvage employer-sponsored retirement plans.

BY ROBERT STOWE ENGLAND

In July, Hewlett-Packard froze benefits in its traditional defined-benefits plan for all but its most senior workers. The technology giant's move is the latest in a growing trend among large employers—once the bastion of defined benefits in the private sector—to freeze defined-benefit and cash-balance plans.

The move came after a benefits benchmarking study of the company and its peers earlier this year prompted its leaders to "make a determination this is a change we need to make," says company spokesman Ryan Donovan.

Indeed, among Hewlett-Packard's peers, IBM late last year announced it was freezing its pension plan to new workers. Further, more technology companies such as Intel and Dell do not offer any type of defined benefits.

The H-P move is just the latest bad news for the DB system. Early this year, UAL Corp. dumped its underfunded pension plan on the Pension Benefit Guaranty Corp., the federal agency that insures pension benefits, just as the agency announced a hefty \$23 billion record deficit.

The UAL plan termination set off a wave of hand-wringing among advocates of the defined-benefit system. "It's been just about the most difficult period for defined-benefit plans in my 20 years here," says James A. Klein, president of the American Benefits Council in Washington.

People have begun to ponder the unthinkable: Can employer-sponsored defined-benefit

plans survive? While unionized industries are expected to retain such plans, the real question is whether it will survive outside those industries—and how large the footprint will be.

The answer depends on the combined effect of key decisions yet to be made around potential reform of the funding rules for defined-benefit plans and a corrosive continuing uncertainty over the legality of cash-balance plans.

The ultimate decision on benefits rests largely with senior management at nonunionized companies. To the extent senior managers continue to perceive defined benefits as helping them attract and retain good workers, and as long as they expect the company to be able to deal with volatile funding requirements, such benefits have a chance of continuing to play a significant role in employer-sponsored retirement plans.

"It's very clear where the trend line is headed," says Shaun O'Brien, pensions specialist with the AFL-CIO. Defined-benefit plans have lost half the workforce share, falling from 38 percent in 1978 to 19 percent, or 21.8 million private-sector workers, in 2002, according to the Bureau of Labor Statistics.

Further, defined-benefit plans are losing ground among larger employers, falling from 91 percent of workers among the 1,000 largest firms in 1985 to 63 percent in 2004, according to Watson Wyatt Worldwide in Washington. "Is there anything to stop that trend? Is there anything to stabilize the defined-benefit world?" O'Brien asks.

Destructive Uncertainties

Washington could improve the outlook for these benefits if it took steps to remove legal uncertainties over cash-balance plans. Indeed, much of the surge in companies freezing benefits is occurring where there are cash-balance plans, according to Alan Glickstein of Watson Wyatt Worldwide's New York office.

Watson Wyatt reports the portion of companies in the top 1,000 U.S. firms that have frozen benefits rose to 7 percent in 2004, up from 4 percent in 2003. "The proportion is higher for cash-balance terminations and freezes, reflecting the unique uncertainty of those plans and general outlook," Glickstein says. Courts have disagreed over whether or not the cash-balance plan discriminates against older workers and Congress has not moved to eliminate this uncertainty.

There are other companies waiting for Washington to act on cash-balance plans. Further delay in addressing them, as well as failure to resolve issues around the funding of plans, can prove to be very damaging to the system. If inaction and inattention remain the norm, the situation may reach "a tipping point, where we may have lost too many plan sponsors who gave up waiting and left the system," making it all but impossible to stabilize the system, according to Glickstein.

Plan sponsors believe proposed changes in federal rules governing how plans value their pension obligations and assets—and ultimately their annual contributions—are at the core of the uncertainty eating away at the defined-benefit system.

Advocates for plan sponsors are vigorously opposed to a proposal put forth by the Bush administration to eliminate the use of an accounting practice of "smoothing," now allowed. Smoothing allows plan sponsors to adjust the current discount rate used to calculate their

benefit obligation to an average rate over a longer period of time. Sponsors claim the practice mitigates the impact of sudden changes in market values and interest rates that could cause a spike in the contribution level at a time when it could be least affordable to the business. When determining their pension contribution, companies have been given the flexibility of selecting a discount rate from a "corridor" or range of values from 85 percent to 115 percent of a four-year rolling average of the 30-year Treasury rate.

If companies instead are required to calculate their level of funding every year using a 90-day window for an investment-grade corporate bond—as proposed by Treasury—the amount of a company's pension obligation would become even more volatile than it is today, according to Judy Schub, managing director for the Committee for the Investment of Employee Benefits Assets.

If Congress were to enact the administration's proposal, Schub says, "you'll see what's slowly happening now to the defined-benefit system become a torrent" as more companies freeze or eliminate healthy plans.

On the other hand, if Congress were instead to make a move to provide employers with a more predictable way to fund their benefits—preferably a smoothing mechanism over several years using investment-grade corporate bonds—it could "stabilize the system and give it a chance to recover," Schub says.

Differing Solutions

Why the divergence on what remedy will work best? Some policy-makers in Washington take a different lesson away from recent volatility in funding than plan sponsors do. Instead of seeing a need to relieve volatility, they believe the rules allow business to camouflage the real state of the pension plan's financial health.

A Government Accountability Office study, *Recent Experience of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, this year reported that underfunding at financially weak firms jumped from \$35 billion in 2002 to \$96 billion in 2004. U.S. Department of Labor Assistant Secretary Ann L. Combs praises the report and suggests that, because of smoothing mechanisms, "plan sponsors and participants discover too late and all too suddenly the need for drastic measures to address severe cumulative underfunding."

PBGC Executive Director Bradley R. Belt echoes that view. "Funding rules are fundamentally flawed and have enabled large funding gaps," he says.

Few observers would disagree with the point that much of the pension shortfall in plans has occurred under lax funding rules sanctioned by Congress. The Employee Retirement Income Security Act, the 1974 pension law, allows companies 30 years to amortize improvements in benefits—"much too long a time period" to cover those costs, says Donald E. Fuerst, senior consultant and actuary in the Denver office of Mercer Human Resource Consulting.

"As a result, companies' general tendency was to minimize cash flow and fund the benefits at the minimum levels," Fuerst says. Further, Congress imposed full funding limits and placed penalties on the recovery of any surplus in the plan, giving companies a disincentive to fund a cushion, he adds.

Belt contends employers have largely created the problem they now complain about

because they failed to contribute to their plan each year "the normal cost of accrued benefits" and further chose not to invest those assets in a way that would limit volatility and funding uncertainty.

Some observers outside the nation's capital would also agree that plan sponsors share part of the blame by underestimating the full cost of the plan. Companies chose to invest in equities partly because they can show a lower expense for the company in terms of paying for the benefit, Fuerst says. However, he adds, "companies didn't recognize the risk [of a downturn] with equities and the need to build up a cushion."

If a company simply funds the "service cost" for each year—the present cost accumulated benefits for that year—the plan will be "in fine shape," Fuerst says. In retrospect, he says, if companies had made contributions equal to service costs each year instead of taking contribution holidays in the late 1990s, they would not be facing shortfalls today.

Fuerst also suggests that companies should use the low end of the statutory range for discount rates allowed. Companies have been "too aggressive" in adopting an interest rate, often in response to "competitive pressures," Fuerst says.

If smoothing were not allowed, companies this year would have to put \$41 billion into their plans instead of the expected \$32 billion, says David Zion, an accounting analyst at Credit Suisse First Boston in New York.

Zion's June 2005 study, *Pension Reform: It's a Cash Flow Issue*, found that many companies—among them Verizon, Merck, Eastman Kodak and Wachovia—would not have to raise their 2005 pension contributions if smoothing were disallowed. However, other companies would have to make sharply higher contributions. General Motors would have to contribute \$2.13 billion instead of \$581 million. IBM would have to contribute \$2.05 billion instead of \$723 million. Delta Airlines would have put in \$1.18 billion instead of \$340 million.

Given the clouds on the horizon for defined-benefit plans, how is an HR executive to respond? For one thing, he or she may want to engage in a practice exercise of re-examining why the company has a defined-benefit plan and whether or not it still suits the needs of the company in the way it did when it was put into place, says Glickstein at Watson Wyatt.

An HR executive may also want to become more engaged in the financial issues surrounding the plan to better understand them and to be prepared to make a financial case for the defined-benefit plan with other executives, Glickstein says.

An HR executive can explain why the plan sponsor has taken on the risk of investing the assets and demonstrate how it has worked out over the longer term—and not just during recent years when interest rates and markets have been adverse. The HR executive can then be prepared to make the case for the return on investment. If HR is more involved with deliberations, a company can take more of a team approach and have a better benefits debate, says Glickstein. This, in turn, may make the difference in whether a valued DB plan that strengthens, not weakens, a company will stay and not go.

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