EBRI
EMPLOYEE BENEFIT RESEARCH INSTITUTE®

NOTES

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Executive Summary:

Experts Track Continuing Evolution of U.S. Pension System

- ***EBRI policy forum:*** EBRI's spring 2007 policy forum, held in Washington, DC, focused on how retirement plan sponsors are reacting to and dealing with major developments in the pension world: Enactment of the Pension Protection Act (PPA) of 2006, which imposed new funding rules on pension plans (among other things), and major new accounting rules issued by the private-sector Financial Accounting Standards Board (FASB) and the public-sector Government Accounting Standards Board (GASB).

- ***The U.S. pension system is continuing to change:*** Experts participating in the forum noted that change has been a near constant in the U.S. pension system. One theme at the policy forum: New accounting rules—rather than new pension funding laws by Congress—may be the determining factor that triggers the next big shake-up in pension coverage. Among the main points discussed:

  → While many large employers say they are committed to their defined benefit pension plans, a number of them either have made changes to restrict benefits or are thinking about making them, leaving their commitment to a pension benefit open to question. So far, pension plan sponsor reaction to the new funding requirements in PPA has been muted.

  → Accounting rule changes that would require employers to show pension and retiree health care costs on their annual financial statements are forcing corporate executives to ponder a host of new issues, including how to adjust pension fund investments to meet the new environment. Many private-sector pension plan managers are moving toward more conservative (stable value) investments to control volatility, while public-sector pension managers are moving toward more risky (equity) investments to achieve higher returns.

- ***"Convergence" with global accounting rules a big concern to U.S. pension managers:*** An anticipated FASB rule—the timing is unclear—that would bring U.S. accounting rules into line with international standards is generating growing anxiety among employers and pension experts. Pension experts predict the rule could have a dramatic negative effect on many plan sponsors' financial reports, which in turn could accelerate the long decline in traditional pension coverage in the United States.

■ Experts Track Continuing Evolution of U.S. Pension System

By John A. MacDonald, EBRI

Introduction

Change is in the air—once again—for the traditional pension system in the United States.

How much change? Where and how will it appear? What is next? Those were some of the questions that the Employee Benefit Research Institute (EBRI) May 2007 policy forum—the organization's 60th such meeting—sought to answer. Among the experts participating in the forum, one theme seemed to emerge: New accounting rules—rather than new pension funding laws by Congress—may be the determining factor that triggers the next big shake-up in U.S. pension coverage.

The policy forum followed a year of major developments in the pension world. Last August, President Bush signed into law the Pension Protection Act (PPA) of 2006, which imposed new funding requirements on pension plans, among other things. Separately, the two major professional accounting authorities in the United States—the Financial Accounting Standards Board (FASB) and the Government Accounting Standards Board (GASB)—adopted certain new accounting rules for pensions and other post-retirement benefits. And among private-sector retirement plan sponsors, a number of high-profile employers either froze their defined benefit pension plans or closed them to new participants, creating a series of doom-and-gloom headlines in newspapers around the country.

"I think we can all agree that 2006 was a momentous year from a host of different perspectives," said Peter Chiappinelli, of Pyramis Global Advisors, a policy forum speaker.

Three of the main points that emerged from the policy forum, which had the alphabet-soup title of "The Impact of PPA, FASB, and GASB on Defined Benefit Plans":

- While many large employers say they are committed to their defined benefit pension plans, a number of them either have made changes to restrict benefits or are thinking about making them, leaving their commitment to a pension benefit open to question.
- Accounting rule changes—known as FAS 158—that would require employers to show pension and retiree health care costs on their annual financial statements are forcing corporate executives to ponder a host of new issues, including how to adjust pension fund investments to meet the new environment.
- Another anticipated FASB rule—the timing is unclear—that would bring U.S. accounting rules into line with international standards is generating growing anxiety among employers and pension experts.

At the outset, Dallas Salisbury, EBRI chief staff executive since its founding in 1978, sought to put recent developments into context. Salisbury noted that EBRI and the Pension Benefit Guaranty Corporation jointly held a policy forum in May 1989 titled, "What Is the Future for Defined Benefit Plans?"

Salisbury read from page 55 of a book recounting the 1989 forum: "Many forces are putting pressure on retirement income plans today, including legislative and accounting standards, the state of the economy, and changing employee and employer attitudes. There are few employers who do not feel that retirement plans (as well as other benefits) have become overregulated. Accordingly, the plan design decisions of most employers are going to be most influenced by the desire to blunt the impact of some of these restrictive developments and reassert as much control over their destinies as possible."

Salisbury added, "I think that's an interesting conclusion from 18 years ago, because it would seem to be still very prescient as a statement of the world that we find ourselves in today. It reminds one of the saying, the more things change, the more they remain the same."

Purely by chance, the Government Accountability Office (GAO), an arm of Congress, issued a report less than a week before the EBRI policy forum that underscored Salisbury's point.

The trends in retirement benefits that have emerged over the last several decades are continuing, the GAO said. Active participation in defined benefit (DB) plans fell from 29 million in 1985 to 21 million in 2003 as employers terminated existing plans or froze benefits for active employees. At the same time, active participation in defined contribution (DC) plans rose from 33 million in 1985 to 52 million in 2003 as employers increased their offerings of these plans. "Benefits experts stated that employers' decisions on what type of retirement plans to offer reflect their preference for benefit cost control and predictability in funding and accounting," the GAO reported.

This shift in retirement plan sponsorship by employers has important consequences for workers, according to an early 2007 study by the Congressional Research Service. "In a DC plan, it is the *employee* who bears the investment risk and who is ultimately responsible for prefunding his or her retirement income," the study said. "As a result of the shift from DB plans to DC plans, workers today bear more responsibility for their financial security in retirement. Decisions that workers make—or fail to make—from the time that they first enter the work force can have a substantial impact on their wealth and income many decades into the future."

Ten experts spoke at the four-hour EBRI forum, which drew about 100 participants. The forum was held May 3 in the Barbara Jordan Conference Center at the Henry J. Kaiser Family Foundation in Washington. The full forum agenda, speakers' biographies, and presentation slides can be found at http://www.ebri.org/programs/policyforums/index.cfm?fa=pfMay2007

The following is a summary of some of the key points made at the forum:

Surveys Offer Two Perspectives on Plan Sponsors' Intentions

Different perspectives on the intentions of pension plan sponsors emerged from two surveys presented at the forum. One suggested employers are largely committed to maintaining pensions for current participants; the other indicated a greater likelihood of change. The details:

Pyramis Survey: Despite headlines suggesting a mass defection from defined benefit plans, Peter Chiappinelli of Pyramis Global Advisors said a Pyramis survey found "a surprisingly strong commitment to existing employees" in plans. Seventy-five percent of corporate plans in the survey reported they are open, with employees accruing benefits, while 25 percent had frozen accruals. Virtually every public-sector plan remained open, with no plan freezes (Figure 1).

Asked what they planned to do in the next three years, 85 percent of corporate plans in the survey said they were committed to the existing defined benefit model—a "relatively strong" endorsement Chiappinelli said.

Chiappinelli said the survey also showed a generational shift is taking place. "If you're a new employee entering the work force today, it is a different story," he said. "The closing of plans is more prominent than the freezing of plans, so new employees will be affected by that behavior."

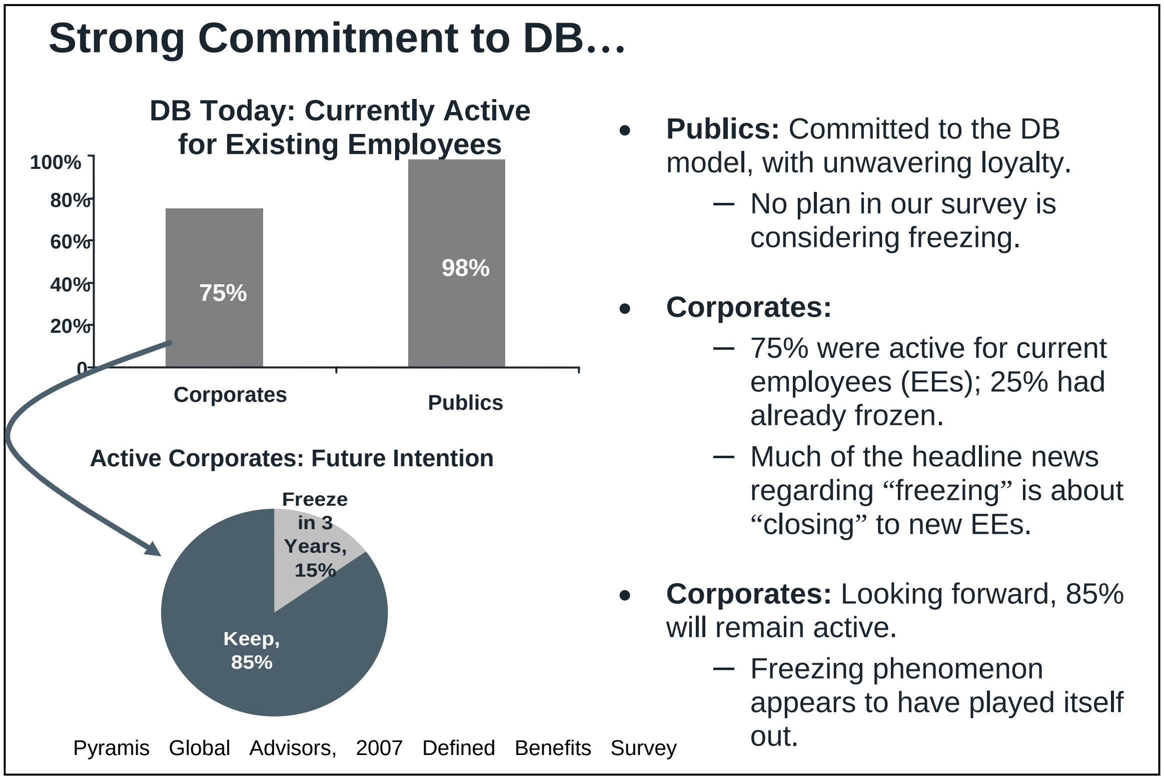
It is well-established that private-sector and public-sector pension coverage is very different (public-sector employers being far more likely to offer a pension plan), and Chiappinelli noted that pension plan costs are viewed very differently by each sector.

"The corporate plan today, when they think about costs of the DB plan, their worry is: I'm at a competitive cost disadvantage. The plan does not give me the financial flexibility that my competitor might have who doesn't have a DB plan," especially global competitors in other countries, he said.

By contrast, he added, public-sector plan sponsors are primarily worried that they are using out-of-date mortality assumptions and that pension beneficiaries are likely to continue drawing pension benefits far longer than the pension plans are budgeting for. "It's no secret that people are living longer and this is a very, very strong worry of the public plan community—the 'baked-in' mortality assumptions they know are wrong, (but) they just don't know *how* wrong they are. The suspicion is that it's a big number."

The Pyramis survey was taken in October–November 2006 and drew responses from 124 corporate and 90 public plans.

Figure 1
Pyramis Survey, Employers' Commitment to Defined Benefit Plans



EBRI/Mercer Survey: Jack VanDerhei, Temple University and EBRI Fellow, and Barbara Marder of Mercer Human Resource Consulting presented preliminary results of an April 2007 EBRI/Mercer survey that had produced 162 responses from employers by the time of the forum, and was on-going. Nearly 70 percent of the survey participants reported they had made some change in the last two years or were considering a change in the next two years (Figure 2)—a level of change that Marder described as "pretty significant."

Closing the plan to new hires and freezing accruals of current employees were the most common forms of change, both in the past and future, Marder said. But she noted that the first step in restricting a pension plan—closing it to new hires—increasingly seems to lead to further limits, especially freezing benefit accruals for current workers covered by the plan.

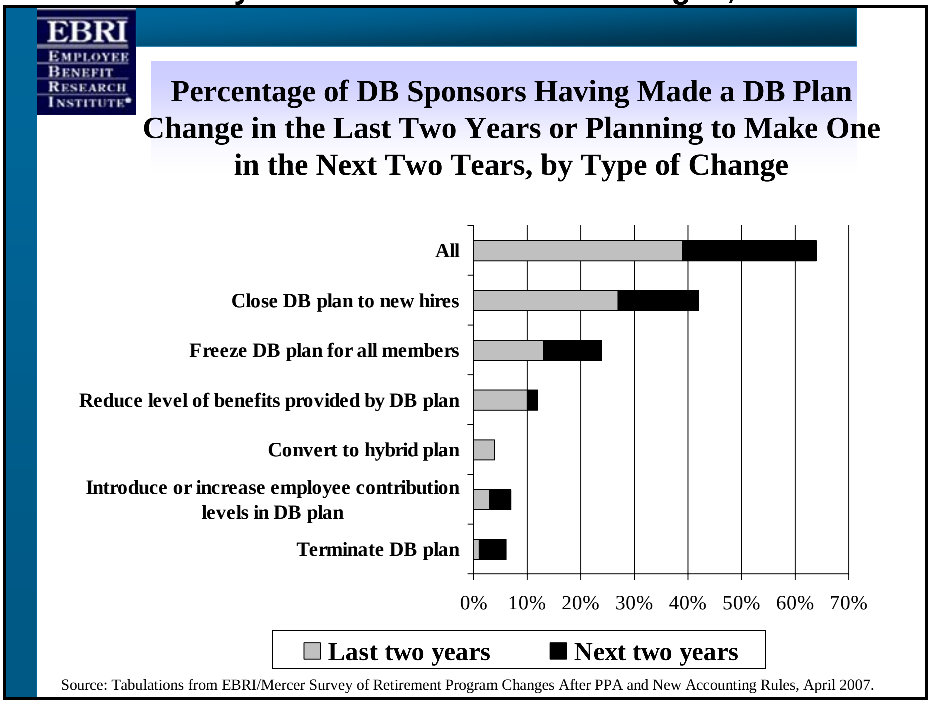
"We're starting to see a pretty significant uptick in actual freezing of these plans [for current workers] that were previously closed [to new workers]," she said. "When employers close their plan, I think their mindset is starting to shift into the defined contribution world."

VanDerhei said the survey showed that larger plan sponsors are "much more likely" to maintain their defined benefit pensions than smaller ones. Full results of the EBRI/Mercer survey are published in the July 2007 *EBRI Issue Brief*, available online at www.ebri.org/publications/ib/

The main drivers of pension plan change are an organization's benefit strategy and making sure that the overall programs meet the needs of the work force and the employer, Marder said, although costs and competitive pressures are very important, too. "To some degree, I think plan sponsors are saying that, if I could stabilize my [pension plan] cost, I can deal with that, even if that ends up with a potentially higher overall contribution level," she said.

Marder said the EBRI/Mercer survey found no clear response to pension plan sponsors' predictions on how they would be affected by enactment of the Pension Protect Act of 2006, which was expected to raise many sponsors' funding costs and tighten pension regulations. "I think it suggests that there's still a lot of uncertainty about what this really means for the balance sheet, for the income statement, for cash contributions," she added.

Figure 2
EBRI/Mercer Survey: Defined Benefit Plan Changes, Past and Future



Source: Tabulations from EBRI/Mercer Survey of Retirement Program Changes After PPA and New Accounting Rules, April 2007.

Pension Act Important, but Reaction Is Muted

One policy forum speaker called the Pension Protection Act the most important piece of legislation affecting pensions in at least a quarter century. Another said the reaction so far has been mild—at least in comparison with the anxiety that had built up before President Bush signed the legislation. Yet another speaker reported the same muted reaction to FAS 158. Here are some of the comments of actuaries and investment advisors who spoke at the forum:

Jerry Mingione, Towers Perrin, described the responses of about 150 employers to three questions in a recent Towers Perrin survey:

- Would expected pension risks be manageable? Sixty-three percent said yes, and 30 percent said [they would be] "acceptable." "The panic when PPA passed wasn't all that pervasive," Mingione said.
- Will pension benefits be curtailed further? Seventeen percent said they would close the plan to future hires. Five percent said they would freeze. Nine percent said they would reduce future benefits, and roughly half said they did not plan any changes. "So: glass half full; glass half empty," Mingione said.
- Will pension fund investment policies change? Thirty-two percent said they would likely put greater emphasis on bonds, rather than stocks, to achieve predictable income. "To the extent that you're investing in bonds, it seems a no-brainer to put greater emphasis on longer duration," Mingione said, and plan sponsors are at least reviewing the option of relying more on fixed income investments and reducing their equity allocations in order to mitigate the risks involved in funding their pension liabilities.

Andre Latia, The Segal Company, told the policy forum that enactment of the Pension Protection Act is the most significant legislation affecting multi-employer (union) pension plans since 1980, and perhaps the most important since the Employee Retirement Income Security Act of 1974, the basic federal law governing employment-based retirement and health benefits.

The key element of PPA, Latia said, is that it takes a long-term view about the financial health of multi-employer pension plans, forcing pension actuaries to determine every year whether a pension plan's funding is critically low (a so-called "red zone plan"), merely endangered (a "yellow-zone plan"), or healthy (a "green zone plan").

"This is quite a formal process, and it's specified in the law; and, in fact, it has specific timeframes upon which the actuary must act [to bring a plan under compliance with PPA funding targets]," Latia said. He noted results of a recent Segal survey of more than 400 multi-employer plans, which showed that about 60 percent were in the green zone, 25 percent in the yellow zone, and about 15 percent in the red zone.

Chris Bone, Aon Consulting, focused on the major changes affecting single-employer defined benefit pension plans as a result of the new FAS 158 accounting rule, the chief one being that the funded status of a pension or a retiree medical plan must now be disclosed on the company's balance sheet, revealing whether there is a surplus or deficit at the end of each fiscal year.

According to Bone's analysis of corporate annual reports, these new rules will affect shareholder equity at many companies. He presented five "off the shelf" examples: A technology company would have a 25 percent reduction in shareholder equity; a large-cap telecommunications company 4 percent reduction; a large-cap bank would have a 1 percent reduction; a utility, no effect; and an auto company, a 159 percent reduction in equity (Figure 3)

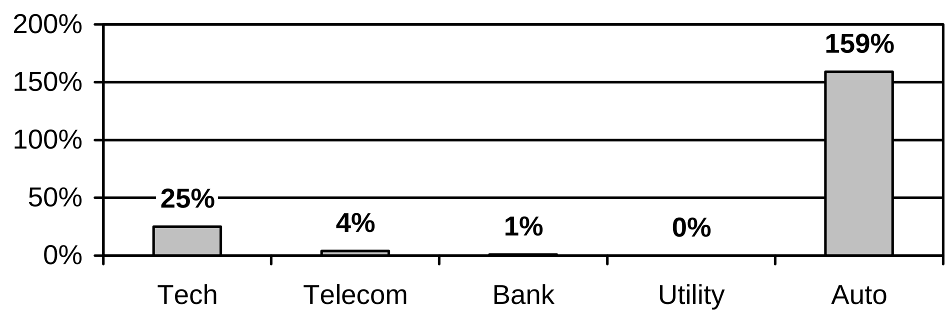
Bone noted that retiree medical costs can be a major factor in the changes. "It's not merely the pension liabilities," he said. "In particular for the auto company, and in general for many of the companies, what generates the liability is the retiree medical benefits because they are often unfunded." But since some plan sponsors do have assets set aside, there is "a pretty significant range of effects now being reflected in the stockholder equity numbers," he added.

Figure 3
Effect of FAS 158 on Shareholder Equity

Balance Sheet Changes

- Liabilities (Projected Benefit Obligation) minus Assets (Fair Value) reported as an asset or liability on the balance sheet.
- Remaining obligations being spread into pension cost over time recognized in accumulated other comprehensive income.

— Stockholders' equity reduced by an offsetting amount.



Source: Chris Bone, AON Consulting, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans.*

William McHugh, J.P. Morgan Investment Management, Inc., said that many pension professionals are now viewing the Pension Protection Act and the Financial Accounting Standards Board rule with less concern than they did while the measures were being drafted. He said the final PPA as enacted is "a lot less draconian than some of the earlier versions were, and many plans and plan sponsors even view it as an effective way to improve the financial health of the overall industry."

Concerning FAS 158, "a lot of clients focus on the fact that it wasn't nearly as bad as they had previously thought, especially given the fact that during 2006, the funded status of the typical plan improved dramatically," McHugh said. "So there wasn't a lot of angst about 158."

McHugh said plan sponsors are developing a new perspective on how pension plans are supposed to work. If sponsors can adapt to the new rules rather than view pensions as a dying benefit, the ultimate result may be "a stronger defined benefit program than we've had in the recent past."

McHugh identified four options that pension fund investment managers could employ to help them adapt to the new rules and regulations:

- Under FAS 158, with a pension plan becoming an on-balance-sheet item, there will be greater pressure from senior management to control pension volatility and risk. This is in the best interest of both plan participants and shareholders because, to a large extent, pension assets are the largest pool of assets for many corporations and pension liabilities are their largest pool of liabilities. "To the extent that you more effectively manage these assets and liabilities, it's a win-win proposition," McHugh said.
- Pension plans have to focus on multiple time horizons. "We no longer have the luxury of taking a very long-term view when we manage the plan," McHugh said. "We have to manage it also in the short term."
- Plans need new measures of risk. "Under the accounting rule changes, the pension plan becomes an integrated business unit of the corporation," he said.
- Plans need customized asset allocation. The one-size-fits-all mindset is not going to work in the future, McHugh said, and pension fund investments must be "customized to what the unique circumstances of the plan and the corporation are."

To accomplish these objections, McHugh predicted companies will begin to implement strategies to more closely match the duration of plan assets to the duration of plan liabilities and to use a broader range of asset classes to reduce the equity risk and exposure by moving into investment vehicles such as private equity, hedge funds, real estate, infrastructure, and commodities such as oil, gas, and timber.

Peter Chiappinelli of Pyramis Global Advisors noted important changes in the investment strategies of both public- and private-sector pension plans. For instance, he said, "conservative old public plans" are seeking to maximize investment returns by investing in international stocks. "For the first time ever, public plans have now not only caught up to corporate plans in terms of investing overseas, but now surpass [them]. That trend is well in place and probably should continue," Chiappinelli said. At the same time, he added, "by a more than three-to-one margin, corporate plans are going to be adding to their bond portfolio—again an historic change."

Historically, pension funds have undergone a "yo-yo effect" in terms of funded status, with plans often following the ups and downs of the stock market, McHugh said. But now, pension plan sponsors are being pushed to dampen overall volatility and construct long-term investment portfolios that will achieve the target rate of return and ensure sufficient assets to cover future pension plan obligations.

What's Next? A New Rule From FASB

What will the much-anticipated new rule from the Financial Accounting Standards Board do? Why are companies nervous? When will it be released?

Bone, of Aon Consulting, provided some answers, beginning with a recap of the 2006 rule (FAS 158) which he referred to as Phase I of FASB's long-term effort to improve financial reporting of pension plan obligations. While Phase I focused on increased disclosure, Phase II will look at integrating U.S. pension accounting rules with international accounting standards, especially those of the European Union, to achieve more consistent international accounting standards.

Bone predicted that Phase II is still "a few years down the road" because of the complex negotiations among multiple accounting standard-setting entities and the need to reach common, effective measurements for post-retirement benefits. But others predict the new rule will be issued much sooner, perhaps even this year in preliminary form.

"It is our understanding that FASB is under a very quick timetable on this," said Greg Dean, an aide to Sen. Mike Enzi of Wyoming, ranking Republican on the Senate Health Education, Labor, and Pensions Committee. "They've told us repeatedly they would like to get something under way by the end of this year, something for people to comment on." Dean said the biggest hurdle to any final rule being adopted is the issue of "convergence"—how to converge U.S. accounting rules with those of the International Accounting Standards Board (IASB).

As several policy form speakers noted, this prospect has many private-sector pension plan sponsors very nervous. For both single- and multi-employer plans, a sudden adoption of IASB accounting rules has the potential to wreak havoc on their financial reports.

"If FASB starts tinkering with the income statement—and FASB has pretty much announced that they are—that's the nervousness that's floating around," said Peter Chiappinelli. "That's the driver of many of the investment decisions that are going on and plan design things that are going on." He predicted many pension plan sponsors will reconsider whether to offer a pension at all "if FASB Phase II kicks in and does a number on [their] income statement."

EBRI's Dallas Salisbury, in a concluding comment, observed that conversations he has had with FASB officials also indicated they planned to have an initial draft of the new rule (known as an exposure draft) by the end of this year. That could serve as a trigger for many plan sponsors to take action that may accelerate the long decline in traditional pension coverage in the United States.

"If there's an exposure draft by the end of this calendar year," Salisbury said, "past experience would suggest that that will cause plan design changes to take place in 2008 on the presumption that most or much of that exposure draft will, in fact, be what ultimately is put into effect."

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■ *New Publications and Internet Sites*

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Health Care

American Hospital Association. *AHA Hospital Statistics*. 2007 Edition. AHA members, $175; nonmembers, $235. AHA Services Inc., P.O. Box 933283, Atlanta, GA 31193-3283, (800) AHA-2626, fax: (866) 516-5817, www.ahadata.com/products

Buck Consultants. *National Health Care Trend Survey*. Seventeenth Edition, First Half 2007. $100. Buck Consultants, an ACS company, Attn: Global Survey Resources, 500 Plaza Dr., Secaucus, NJ 07096-1533, (800) 887-0509 or (201) 553-6400.

Mercer Human Resource Consulting. *National Survey of Employer-Sponsored Health Plans, 2006 Survey Report*. Report, $500, Report and tables, $1,000 (tables not sold separately). Mercer Health & Benefits, Attn: Tara Lewis, 1166 Avenue of the Americas, 29th floor, New York, NY 10036-2708, (212) 345-2451, e-mail: tara.lewis@mercer.com

Pension Plans/Retirement

Hodge, Paul. *Baby Boomer Women: Secure Futures or Not?* $26.95. Global Generations Policy Institute, 124 Mount Auburn St., Suite 200N, Cambridge, MA 02138, (617) 491-1171, fax: (617) 547-1431, e-mail: genpolicy@genpolicy.com, www.genpolicy.com

HR Investment Consultants. *401k Averages Book.* 8th Edition. $95 + S&H. HR Investment Consultants, 305 West Chesapeake Ave., Suite 205, Towson, MD 21204, (888) 401-3089 or (410) 296-1081, ext. 10, e-mail: info@401ksource.com, www.401ksource.com

Ng, Karen, and Corey Rosen. *Model ESOP*. 3rd Edition. NCEO members, $50; nonmembers, $75. National Center for Employee Ownership, 1736 Franklin St., 8th Floor, Oakland, CA 94612, (510) 208-1300, fax: (510) 272-9510, e-mail: nceo@nceo.org, www.nceo.org

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U.S. Government Accountability Office. *Social Security Reform: Greater Transparency Needed about Potential General Revenue Financing*. Order from GAO.

Work and Family

Bailyn, Lotte. *Breaking the Mold: Redesigning Work for Productive and Satisfying Lives*. Second Edition. $17.95. Cornell University Press, P.O. Box 6525, 750 Cascadilla St., Ithaca, NY 14851-6525, (607) 277-2969, fax: (800) 688-2877, www.cornellpress.cornell.edu

Work Force

Gleason, Sandra E. *The Shadow Workforce: Perspectives on Contingent Work in the United States, Japan, and Europe*. $22. W.E. Upjohn Institute for Employment Research, Attn: Publications Department, 300 S. Westnedge Ave., Kalamazoo, MI 49007-4686, (888) 227-8569 or (269) 343-5541, fax: (269) 343-7310, www.upjohninstitute.org

Mishel, Lawrence, Jared Bernstein, and Sylvia Allegretto. *The State of Working America 2006/2007*. $24.95. Cornell University Press, P.O. Box 6525, 750 Cascadilla St., Ithaca, NY 14851-6525, (607) 277-2969, fax: (800) 688-2877, www.cornellpress.cornell.edu

Web Documents

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www.bcbs.com/betterknowledge/mcrg/MCRG.pdf

Early Retiree Health Insurance Issues
www.tiaa-crefinstitute.org/research/trends/docs/tr0307.pdf

GASB 45: New Standards in Reporting OPEB
www.nagdca.org/resources/nagdca_notes/notes04-07.pdf

Genetic Discrimination: Overview of the Issue and Proposed Legislation
www.opencrs.com/rpts/RL33903_20070307.pdf

Growing Older in America: The Health & Retirement Study
www.nia.nih.gov/ResearchInformation/ExtramuralPrograms/BehavioralAndSocialResearch/HRS.htm

Health Care Coverage in America: Understanding the Issues and Proposed Solutions [Updated March 2007]
www.allhealth.org/publications/Uninsured/Health_Care_Coverage_in_America_2007_54.pdf

Health Care Spending and the Aging of the Population
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www.dol.gov/ebsa/PDF/2004pensionplanbulletin.pdf

Qualified Domestic Relations Orders & PBGC [Booklet]
www.pbgc.gov/docs/QDRO.pdf

The Recent Trend Towards Later Retirement
www.bc.edu/centers/crr/issues/wob_9.pdf

Regulation of Health Benefits Under ERISA: An Outline
www.opencrs.com/rpts/RS22643_20070412.pdf

Status of the Social Security and Medicare Programs: A Summary of the 2007 Annual Reports
www.socialsecurity.gov/OACT/TRSUM/trsummary.html

Stock Options: The Backdating Issue
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Top CDHP Providers for Employer-Sponsored Plans
www.workforce.com/tools/hot_list/070409_HotList.pdf

Utilization of Tax Incentives for Retirement Saving: Update to 2003
www.cbo.gov/ftpdocs/79xx/doc7980/03-30-TaxIncentives.pdf

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