



The U.S. Pension Crisis

Evaluation and Analysis of Emerging Defined Benefit Pension Issues

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7315 Wisconsin Avenue • Suite 600 West • Bethesda • Maryland 20814
Phone: 301.907.2862 • Fax: 301.907.2864
www.CIEBA.org • www.AFPonline.org • CIEBA@AFPonline.org
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Executive Overview

CIEBA Report on Emerging Pension Issues

For the past several decades, the U.S. corporate defined benefit (DB) system has contributed significantly to the retirement needs of millions of Americans. Consequently, the aggregate long-term retirement system in America is perhaps the finest in the world. Today, however, that system is under attack and the future stability of the U.S. pension system is at risk.

Recent threats come from the unintended, and inadequately considered, implications stemming from an unprecedented, and largely uncoordinated, series of emerging accounting, legislative and regulatory initiatives. Specifically, those initiatives include new accounting methods under consideration by the Financial Accounting Standards Board (FASB), funding rules crafted by the Treasury Department, proposed changes to the Pension Benefit Guaranty Corporation's (PBGC) risk premium system, and the means by which various rating agencies treat pension obligations.

Collectively, these issues could redefine the measurement of corporate DB plans, increase their long-term costs, lower benefits paid to millions of participants and potentially upset the U.S. equity market. Unintentionally, emerging pension rules and regulations could further reduce the funded status of America's major corporate pension plans and threaten the future security of the nation's retirement system.

Taken collectively or individually, U.S. corporations are likely to interpret these emerging initiatives as major alterations in the fundamental underpinnings that have supported the corporate commitment to DB plans for more than two decades. The intermediate impact could be a potentially massive move out of stocks into bonds and the initiation of a secular process whereby pension benefits would decrease for millions of participants.

This report, therefore, attempts to provide some of the actual data needed to analyze the potential effects of these emerging pension issues properly. It also serves as a reminder that our nation boasts a sound, long-term national retirement strategy based on a foundation of core benefits (Social Security and DB pension plans) and flexible benefits (personal savings and defined contribution [DC] plans). It is the ratio and health of those two types of retirement programs that allow us to achieve our long-term corporate and societal goals.

CIEBA's Objective

What is needed is serious, objective and particularly collective reflection on how to best fund, account for, invest and support our nation's pension system. This report was prepared with that objective in mind.

Legislators, regulators and standard setters need to recognize that healthy pension reform must be broadly coordinated. CIEBA calls on them to meet together with representatives of plan sponsors and participants to develop a blueprint for considering pension reforms that takes into account the collective consequences as well as the individual impact of any proposed changes.

Summary of the CIEBA Report

The data and analysis provided in this report include the following:

- Data on historical and prospective investment behavior supplied by more than 60 senior corporate investment officers, representing approximately \$500 billion in pension assets.
- Data on the current structure of corporate defined pension benefits and the potential implications of these various emerging issues on future benefit levels.
- A review of the relevance and importance of the U.S. corporate pension system to the country as a whole, and, specifically, to nearly 35 million Americans.
- A macro-economic evaluation of the potential, aggregated effects of these emerging pension issues on growth of the U.S. economy, employment, the U.S. equity market, interest rates and, ultimately, the funded status of corporate pension plans.
- A microanalysis of the actual effects and real-world implications of several of the most controversial, emerging proposals.

The following are some of the key findings in this report:

- Seventy-five percent of large U.S. corporations continue to offer a DB pension to their employees.
- DB plans currently cover approximately 35 million Americans and their families. This is an all-time high.
- Approximately 50% of corporations are likely to seriously consider reducing pension benefits if these pension initiatives are adopted.
- Corporations have been stable and effective long-term investors, primarily through disciplined, long-term commitments to the world's equity markets. As a result, the median 10-year return for corporate pension plans has been approximately 9.4% per year, while the corporate return on asset assumption over the period has been approximately 8.8%.
- Approximately 75% of aggregated pension liabilities continue to relate to traditional, final average pay plans, although new and more flexible plans have been implemented over the past several years.
- Issues most likely to have serious individual effects are as follows: the potential cessation of accommodating long-term investing practices via smoothing realized and unrealized gains and losses over several years (FASB); the movement to an unsmoothed yield curve approach by the Treasury Department for determining required pension funding; and the alteration of the risk premium system currently used to fund the PBGC. Each factor will individually discourage long-term equity investing. Collectively, they may prove to be overkill, and have significant and outsized unintended consequences.
- Approximately 75% of senior investment officers would alter their plan's asset allocation policy significantly, always by selling stocks and buying bonds – potentially in a major scramble for duration.
- The implied asset shift could potentially exceed \$650 billion dollars and cause a decline of perhaps 10% in the U.S. equity markets, while also causing interest rates

to fall and the yield curve to flatten. The long duration, investment grade bond market cannot effectively accommodate flows of this magnitude today.

- The fall in stock prices, combined with the decline in interest rates, would have the unintended consequence of reducing the funded status of most pension plans by perhaps 10% or more. There would also be moderately negative impacts on general economic activity and employment trends.
- The cessation of accommodating long-term investment practices via smoothing is an emerging accounting convention in Europe, where the corporate pension system bears little resemblance to that in the U.S. Much of Europe's system is largely unfunded and is smaller. If adopted here, the percentage increase in annual earnings volatility could approach 25%, while also mismatching the timing of assets and liabilities, and treating the pension system completely different than other "debt" on the corporate balance sheet.
- The use of an unsmoothed corporate yield curve for funding purposes would potentially double or triple the expected volatility in annual funding, with essentially little or no intermediate-term increase in the accuracy of the actual secular estimate of the underlying pension obligation. Potentially, its use would seriously undermine other governmental efforts to manage the U.S. economy effectively.
- The alteration of the PBGC risk premium system toward a system based on equity exposure is misguided. The PBGC has not demonstrated that the equity exposure of terminated plans was an important factor in the failure of various plans. In addition, the current proposal does not consider either the quality of the sponsor or its individual funded status. The actual long-term impact on the PBGC may also be significantly overstated, once actual historical default rate data is considered.
- If the corporate DB system is undermined, lower income Americans are likely to be affected most, increasing the pressure on government programs to make up the potential shortfall, at a time when those programs are under stress already

Most DB plans are sponsored by financially solvent "going concerns," capable of operating over lengthy time horizons that match the long-term nature of pension obligations.

The U.S. corporate pension system has matured along with the country's demographic cycle. Active participants in the aggregate national DB system are now roughly equal to inactive participants (primarily retirees).

Because of the impending retirement of the Baby Boom generation, the U. S. pension system is more important to the nation and to beneficiaries than ever. Major changes that have the potential to do real damage should not be undertaken lightly and simply in response to the unique market conditions of 2000-2002.

Legislators, regulators and standard setters need to recognize that healthy pension reform must be broadly coordinated. Therefore, CIEBA's hope is that a collective process can be established that includes plan sponsors, key policy makers and standard setters. Within that collective forum a viable, long-term and comprehensive blueprint for properly considering pension returns can be implemented. Furthermore, within that framework a comprehensive review of the funding rules and the regulatory regime that governs DB plans would be both desirable and appropriate. However, it is critical that any proposed changes be considered collectively, and not in isolation.