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### 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 oversized 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.

### The CIEBA Project on Emerging Pension Issues

In the fall of 2003, the Committee on the Investment of Employee Benefit Assets (CIEBA), which represents more than 110 of the nation's largest pension and retirement funds, initiated a two-part study to provide background and objective analysis on emerging pension issues. In the first part of the project, CIEBA canvassed its members on the current status of their pension plans and ways their plans might change in response to the emerging issues. Sixty-five CIEBA members responded to the study, *CIEBA Survey on Emerging Issues*, representing almost \$500 billion in DB plan assets. CIEBA also compiled 10 years of historical data on plan asset management from its annual membership profile surveys.

For the second part of the project, a team of financial and economic experts was invited to provide independent analysis. The following firms offered significant support for this project: Goldman, Sachs (GS), Morgan Stanley (MS), Hewitt Associates and Bridgewater Associates. *[See Appendix A for a full list of individual experts.]* Each of the four firms produced a report examining the impacts of emerging issues on pension plans, retirement security for American workers and retirees, and/or potential effects on the larger economy. It should be noted that CIEBA does not endorse all views expressed herein. *[See Appendices B-F for those full reports.]*

This report is a summary and evaluation of the CIEBA member survey, the data collected, and the reports produced by the outside experts.

### CIEBA's Outlook on the Emerging Pension Issues

CIEBA was formed in 1985 to provide a nationally recognized forum and voice in public policy for ERISA-governed corporate plan sponsors on fiduciary and investment issues. Members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets. Focused on the issues of pensions, CIEBA is a committee of the Association for Financial Professionals (AFP), the membership organization of global corporate financial professionals. AFP is comprised of more than 14,000 individual members from a wide range of industries.

CIEBA today represents more than 110 of the nation's largest pension and retirement funds. CIEBA members manage \$1 trillion of plan assets on behalf of 15 million plan participants and beneficiaries. More than one-quarter of all participants in corporate DB plans are in plans managed by CIEBA members.

Since its founding, CIEBA has been committed to strengthening the private sector retirement system so it can continue providing retirement income for millions of Americans. CIEBA strongly believes that the pillars necessary to assure adequate retirement income for most Americans are: 1) a healthy, universal public system (e.g., Social Security); 2) strong employment-based retirement plans (e.g., both DB and DC plans); and 3) individual savings. Undermining key components of any of these pillars will endanger the future retirement security of millions of American families.

CIEBA members also recognize that the private retirement system's assets provide a significant source of long-term capital essential for growth.

## Challenges Facing Defined Benefit Pension Plans

We are entering a period of potentially unprecedented change in the ways U.S. corporate pension plans are regulated, accounted for and funded. Policymakers, opinion leaders, regulatory and quasi-regulatory organizations, and other stakeholders are all considering proposals that would significantly alter the way pension plans operate. These proposals represent a massive change in the “rules of the game” that have supported the DB system for more than a decade.

Many of the emerging issues stem from the unprecedented period experienced between 2000 and 2002. While adverse periods can produce positive change, they also can trigger an over-reaction that compounds the problem with unintended, negative consequences. Further, each of the emerging issues represents a single response by an independent entity, with little or no consideration of their overall effects.

The corporate DB pension system is too important to major corporations (and the U.S.) to simply institute many or all of the proposals without an extensive and objective analysis of their individual and, more importantly, their collective impact.

## Overview of Emerging Pension Issues

A number of proposals have been advanced to fundamentally change the way traditional pension plans are treated under current accounting and funding rules, by credit rating agencies and the PBGC, the government corporation that insures pension plans. Proponents argue that the changes will make systemic measurements more accurate, increase transparency for investors and reduce risk for the PBGC. However, there has been little or no research to support these contentions.

### **Emerging Pension Issues:**

There are seven main issues being debated on various levels today:

#### Accounting

**Elimination of smoothing** (FASB) – Under current rules, pension plan assets and liabilities are averaged over several years when reported on corporate balance sheets. This averaging or “smoothing” reduces earnings volatility.

**Increased disclosure** (FASB) – FASB recently put in place new rules requiring companies to disclose more information about their pension plan assets, benefit costs and obligations, and cash flows.

**Redefinition of core earnings** (Rating Agencies) – Standard & Poor’s and other rating agencies are moving to a definition of core earnings that diminishes the importance of pension fund returns.

#### Funding

**Discount rate reform** (Congress) – Under current law, pension plan sponsors must use a weighted average of the 30-year Treasury bond interest rate for plan funding and other purposes. Legislation has passed both Houses of Congress to replace the 30-year T-bond rate with a rate based on a high-quality (Aa or better), longer-term corporate bond index for the next two years.

**Use of an *unsmoothed* corporate yield curve** (Treasury) – The Administration has proposed eliminating a single “smoothed” discount rate for calculating plan liabilities. This proposal requires use of an “individualized” discount rate based on the age of the covered population in a plan.

#### Credit Ratings

**Treatment of the Projected Benefit Obligations (PBO) as debt and the reflection of the risk of various asset classes in ratings** (Rating Agencies) – Standard and Poor’s and other rating agencies have moved to explicitly treat pension plan PBO as corporate debt.

#### Pension Benefit Guaranty Corporation (PBGC)

**Alteration of the risk premium system toward one based primarily on equity exposure** (Academia) – Currently, the amount of the PBGC’s variable rate premiums relates directly to the amount of underfunding in pension plans. Proposals have been discussed to relate the variable rate premium to the equity proportion in a pension plan’s portfolio. Greater exposure to equities would engender higher premiums.

## Guiding Principles Governing Defined Benefit Plans

As the largest organization of corporate pension fund managers, CIEBA believes that America's corporate pensions face a severe crisis that, if not addressed, will threaten the U.S.' retirement strategy. In conducting its analysis of the current, disparate issues challenging the pension system, CIEBA is focused on a core set of guiding principles that include:

- I. DB Plans are Desirable and Serve Beneficiaries Well
  - DB plans are the financial cornerstone of retirement security for more than 35 million Americans and their families.
  - Plans generally provide universal coverage to workgroups, whereas 25+% of workers opt out of DC plans.
  - Participants are insulated from investment risk, mortality risk, etc.
- II. DB Plans are Long-Term in Nature
  - Participants work 20-30 years and receive benefits for 10-20 years.
  - Investment decisions should be made recognizing long-term horizons.
  - Regulations on funding and accounting should be based on long-term factors, not shorter-term market cycles.
- III. Funding Rules Should be Flexible
  - Limits on funding in good economic environments should not be overly restrictive.
  - Forcing excessive contributions in recessions counters sound monetary policy.
- IV. DB Disclosures Should be Transparent and Provide Investors With Relevant Information
- V. DB Plans' Policy-Making Should be More Integrated to Ensure Different Prescriptions Don't Kill the Patient
  - Today, multiple groups (IRS, FASB, DOL, Congress, PBGC, etc.) set various policies based on a specific focus without considering their overall impacts on the system.
- VI. The Complexity of Rules and Regulations Governing DB Plans Should be Reduced
  - Multiple, and often contradictory, methods drive excess costs (i.e., different discount rates for funding, accounting, lump sums, etc.).

Why are Corporate Defined Benefit Plans Important?

**Hewitt Associates**

- DB plans are a successful and critical part of the U.S.' long-term retirement system. Currently, DB plans cover more than 35 million American employees and their families. Approximately 75% of companies in the Fortune 500 provide a DB pension.
- DB plans represent one of the four pillars of long-term retirement savings. The four pillars can be categorized into Core Vehicles (Social Security and DB plans) and Flexible Vehicles (DC plans and personal savings).
- DB plans are a core retirement system for Americans. DB plans: feature open participation regardless of age or level; generally do not require employee contributions to participate; allocate costs properly to tenured employees; and accrue benefits regardless of changing economic or financial market conditions.
- DB plans can provide substantially more "benefits per dollar" than other retirement savings methods (e.g., DC plans, etc.). Specifically, an extra 1% return from a DB plan can often support up to a 25% increase in future benefits.
- DC plans are not primarily core retirement programs. They generally require elective participation via an employee contribution. Approximately 25% of employees do not choose to participate at any level and 40% of employees earning less than \$40,000 do not participate at all; those who do contribute a substantially lower percentage of their income than higher-paid participants.

Defined Benefit Plans are Relatively Effective and Stable Investors are Able to Invest for the Long-Term

**Hewitt Associates**

- DB plans serve as effective, core retirement programs because they both transfer investment risk and generally produce higher, long-term returns.
- Generally, DB assets are invested more effectively, and are more diversified, disciplined and stable.
- Aggregation produces lower costs and allows for increased risk sharing.
- DB plans are generally supported by high-quality corporate enterprises, viewed as long-term going concerns with either strong, current cash flow, ready-access to financial markets, or both.
- DB plans are highly attentive to total portfolio risk and carry significantly less "Enron" risk (e.g., specific risk).
- The median annualized return earned by large corporate pension systems for the 10 years ending December 31, 2003 was 9.4%, slightly above the long-term annualized return on assets (ROA) assumption over that period, which averaged between 8.5% and 9.0%.
- According to the Dalbar study, over the period from 1984 through 2000, the S&P 500 rose 16.3% per year. However, individual equity investors in U.S. mutual funds earned less than 5.2%. This disparity is attributable to a number of factors, including poor market timing by individuals. Over this same period, the median corporate pension plan earned a return of 13.1% (while generally holding 25% of their portfolios in fixed income).

According to Hewitt Associates, the median, long-term expected return of a typical corporate investment portfolio is approximately 8.8%. In addition, the projected range of potential outcomes narrows considerably as the time horizon lengthens to one consistent with a typical pension plan. [See Exhibit 1.]

**Exhibit 1: Rate of Return at a Given Confidence Level**

Time Horizon in Years	95 <sup>th</sup> Percentile	75 <sup>th</sup> Percentile	50 <sup>th</sup> Percentile	25 <sup>th</sup> Percentile	5 <sup>th</sup> Percentile
1	-12.13%	-.031%	8.83%	18.81%	34.79%
3	-3.82%	3.45%	8.83%	14.48%	28.13%
5	-1.10%	4.64%	8.83%	13.18%	19.75%
10	1.71%	5.85%	8.83%	11.89%	16.45%
20	3.75%	6.71%	8.83%	10.98%	14.16%

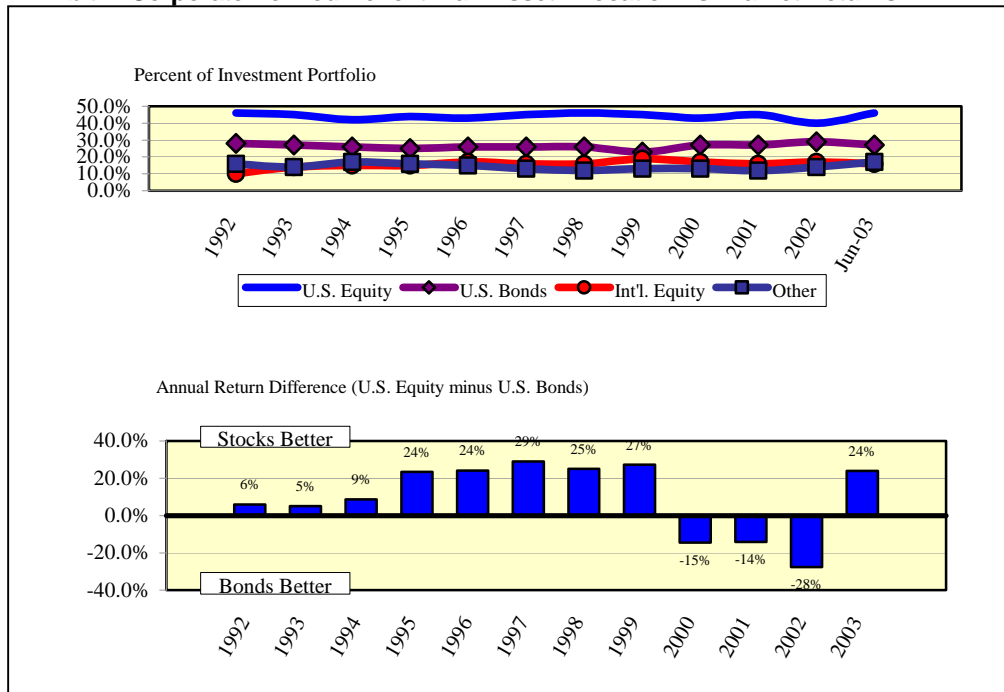
Source: Hewitt Associates

**What Have Defined Benefit Plans Earned vs. Their Return on Asset (ROA) Assumptions?**

Median DB plan 10-year return (through December 31, 2003) = 9.4%  
 Estimated average ROA assumption over same period = 8.8%  
 Sources: Mellon Pension Trust Universe and CIEBA

Achieving these returns is the primary result of exceptionally stable and disciplined investing, using U.S. equity as the Trust’s primary investment asset class.

**Exhibit 2: Corporate Defined Benefit Plan Asset Allocation vs. Market Returns**



Sources: (Top Chart) CIEBA Annual Membership Profiles; (Bottom Chart) CIEBA, based on data from the Federal Reserve

## How Have Defined Benefit Plans Performed vs. the Average Individual Investor?

Median 17-year return (through December 31, 2000) = 13.1%

Average individual investor return for same period = 5.2%

Sources: Mellon Pension Trust Universe and the Dalbar study

Employees invested in a typical DC plan during the period 2000-2002 experienced a significant reduction in their portfolio's value and thus, their benefit.

One of the reasons plans tend to hold equity investments is that equity risk generally diminishes as holding periods increase. Exhibit 3 demonstrates that historical fact, using various time horizons and expected risk premium associated with equity investment.

For example, the standard deviation of real equity returns declines from 5.9% to 1.5% as the time period expands from 10 to 30 years. In addition, the risk of realizing a real annualized return of less than 3.5% drops from 37% to 10% over those two periods (assuming that stocks outperform bonds by 2% per year). Over the same period, the risk of a real return below inflation (e.g., below 0%) declines from 18% to 0%.

### Exhibit 3: Expected Excess Return on Equity

Holding Period	Standard Deviation*	Expected Excess Return on Equity	Risk of Real	Risk of Real
			Annualized Returns Below 3.5%	Returns Below 0%
10 Years	5.9	1%	43%	22%
		2	37	18
		3	31	14
20 Years	3.3	1	38	8
		2	27	5
		3	18	2
30 Years	1.5	1	26	0
		2	10	0
		3	3	0
40 Years	1.4	1	24	0
		2	8	0
		3	2	0

\* Standard deviation of annualized real equity market returns over the holding period

Source: Robert Shiller; Goldman, Sachs

## Defined Benefit Plans Also Protect Employees From a Host of Additional, Long-Term Risks

Hewitt Associates
<ul style="list-style-type: none"> <li>▪ Annuities reduce the risk of longevity/aging, reducing the likelihood that individuals will outlive their resources.</li> <li>▪ In plans that provide early retirement subsidies, the less healthy can retire as necessary, without a large penalty (reduced morbidity risk).</li> <li>▪ Inflation risk is eliminated during employment by final average pay or inflation-adjusted, flat-dollar plans. Inflation risk may also be reduced by traditional pension plans providing ad hoc Cost of Living Adjustments (COLAs) after retirement.</li> </ul>

## Historically, U.S. Corporations Have Supported the Defined Benefit System

### Hewitt Associates

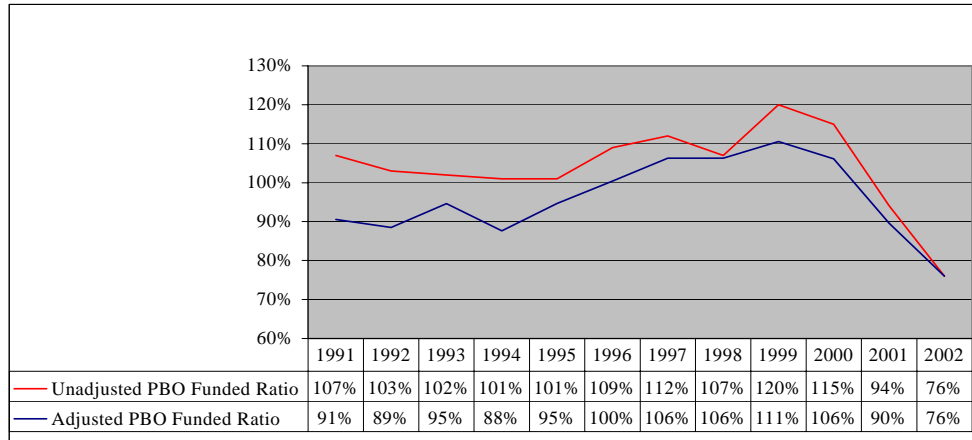
- Although the number of DB plans declined dramatically over the past decade, that decline stems almost exclusively from the exit of very *small* companies (due to perceptions of excessive regulatory requirements), and the consolidation of plans by larger employers. To date, very few *large* sponsors of corporate DB plans have exited the system.
- While the percentage of companies in the Fortune 500 with DB plans has declined from 90% in 1991 to 75% today, the actual number of participants covered increased from 31 to 35 million.
- Companies have tried to respond to changing conditions, such as a more mobile workforce, by introducing hybrid plans that better match the current workforce and better suit corporate needs.

## What's New Today?

### Hewitt Associates

- Many observers feel that current conditions are likely to cause many employers to exit the DB system. Some have already begun to freeze future benefit accruals.
- Unprecedented financial market conditions have lowered the funded status of many corporate plans, increased pension expense and caused some companies to contribute large sums to support their pension programs. Many observers have called the 2000-2002 period the “perfect storm.”
- Interest rates, both nominal and real, are at or near 50-year lows. The yield curve is at, or near, as steep as it has ever been. Short-term rates are below inflation.
- Tightened funding rules adopted in the late 1980s have caused a large cash call on many companies, just at a time when cash is in short supply.
- There has been unusual uncertainty injected into the future of the funding rules, as Congress has not finished work on the discount rate. The accounting profession is “piling on,” suggesting changes that could increase the volatility of corporate earnings substantially.
- The PBGC is openly campaigning for additional reform.
- The aggregate U.S. pension system is maturing. In 1990, the ratio of the PBO to the Accumulated Benefit Obligation (ABO) was 125%. Today, it is approximately 107%. In 1985, the ratio of active employees to inactive plan participants (primarily retirees) was approximately 80/20. Today, that ratio is approximately 50/50. In the future, retirees are virtually certain to outnumber active employees [*See Exhibit 6.*].

**Exhibit 4: Assets as a Percent of Projected Benefit Obligations (PBO)**



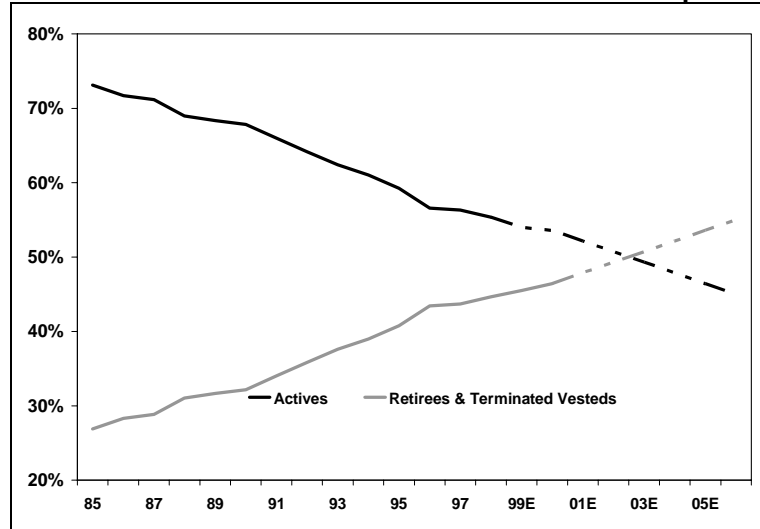
Source: Hewitt Associates

**Exhibit 5: 10-Year U.S. Treasury Bond Yield**



Source: CIEBA

**Exhibit 6: Active vs. Retired and Terminated Plan Participants**



"E" along the horizontal axis means "estimated."

Source: Morgan Stanley

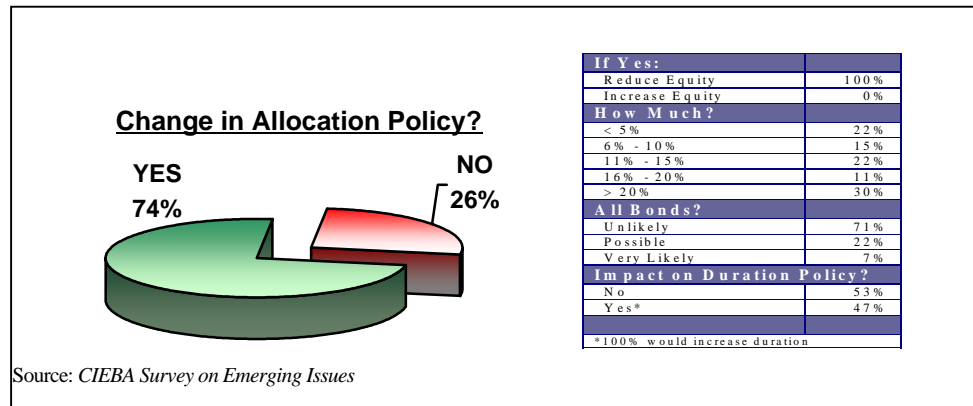
## Reaction of Pension Plan Sponsors to Emerging Pension Issues

Corporate DB pension plan sponsors' reactions to these emerging issues are likely to be significant and swift.

Seventy-five percent of plan sponsors who participated in the *CIEBA Survey on Emerging Issues* are likely to respond by making significant changes to their asset allocations, principally by lowering long-term equity holdings by approximately 15% and re-investing the proceeds in long-term bonds. Assuming reasonable follow-on effects, this could represent a shift of up to \$650 billion for the extended system. (This does not take into account the likely, additional flows created by information-based, short-term trades [e.g., hedge funds, etc.] )

Exhibit 7 summarizes the expected asset allocation response of major U.S. corporations to the collective impact of the emerging pension issues.

### Exhibit 7: Collective Impact on Asset Allocation of Emerging Issues



### Exhibit 8: Projected Hierarchy of Individual Issue Impact

Individual Issue	Asset Allocation Action	
	No Change	Change
1. FASB Elimination of Smoothing	55%	45%
2. Treasury Requires Corporate Yield Curve	55%	45%
3. PBGC Alters Premium System	51%	49%
4. Discount Rate Becomes Single Long-Term Corporate Rate	98%	2%
5. Rating Agencies Treat PBO as Debt	67%	33%
6. Broad Adoption of S&P's Redefinition of Core Earnings	71%	29%
7. FASB Requirement to Increase Disclosure	92%	8%

Approximately 50% of plan sponsors in the CIEBA survey indicated they would also consider a reduction in benefits offered (e.g., a discontinuation of future accruals for existing participants, elimination of benefits for future employees, migration toward hybrid plans and, for some, the complete elimination of their DB system).

### Exhibit 9: Collective Impact on Benefit Structure

Benefit Change	Unlikely	Possible	Very Likely
1. Freeze Accruals to Existing Entrants	53%	38%	9%
2. Freeze Entry of New Participants	47%	32%	21%
3. Switch to Cash Balance Plan	61%	28%	11%









































































































































































