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STAY TUNED ... to Pension Funds, Healthcare for Retirees

By Hank Boerner

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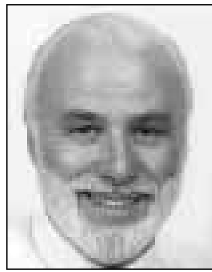
STAY TUNED ... to Pension Funds, Healthcare for Retirees

To hear some in government tell it, there is a dark foreboding in the world of corporate finance: It's called underfunded and failing corporate defined benefit pension plans for employees. Too much red ink in some plans, including those of large firms, poses a real threat to the federal government and taxpayers — short and long term.

True, this underfunding situation *could* pose a threat to (1) current retirees, if their defined benefit plans should fail; (2) future retirees, if no pension plan is there for them; (3) U.S. taxpayers, if a federal bailout is necessary to provide the statutory level of safety to beneficiaries of failed plans; and (4) many corporate bottom lines, if federal regulators or lawmakers require fresh cash infusion or accelerated catch-up payments be made for lagging pension funds. The latter may be in the works, and corporate earnings could soon be affected. (Treasury Department sources have been quoted saying that the administration is looking into accounting treatment changes for pension plans.)


Hank Boerner

The counterargument from the corporate suite, however, is that, yes, fund returns on investments have been affected by the sluggish market returns of the past three years, but with the economy and market turnarounds under way, healthy returns on investment will soon boost fund balances to appropriate levels to cover future payouts. Not everyone is retiring tomorrow, so funding for the long term is the focus. A spokesperson for the American Benefits Council notes that imposing burdens on companies — such as new federal funding rules — might force some companies to immediately discontinue their plans. Employees in the plans would probably not react very well to the news their plan is going away.

Stay Tuned to ... PBGC: Pension Benefit Guaranty Corporation is the federal agency created by Congress to provide pension insurance for defined benefit corporate plans, similar to the FDIC insurance for bank customer deposits. Corporations pay annual premiums for their plans, and the pool covers corporate plans that fail due to bankruptcy or other reasons.

Today, PBGC says it has the largest deficit in its 30-year history: in excess of $11.2 billion (at year end) in its single-employer program. (The 2002 deficit was $3.6 billion.) Public- and private-sector estimates of the total underfunding of all insured plans range up to an astonishing $300 billion, depending on who is doing the counting. (PBGC confirms an $85 billion current long-term risk exposure.)

PBGC is supposed to be self-funded and generate income and reserves through insurance premiums paid by covered companies, by assuming assets from terminated corporate plans and bankruptcy recoveries and from earnings on invested assets. The agency has been shifting its own investments away from equities and into "safer" bonds and stock-like instruments — and apparently is encouraging corporate pension fund managers to take a serious look at using the same investment management approach.

The agency is currently paying monthly pensions to more than 450,000 retirees of failed plans, totaling $2.5 billion in 2003. The agency earned $3.3 billion on investments. Total assets are $34 billion today vs. liabilities of $45 billion.

Termination of large defined benefit plans — LTV Steel, Polaroid, USAir and other companies in the steel and airline industries (40 percent of failures) — and declining share prices of the agency's own equity investments have steadily eroded PBGC's asset base over the past three years.

Reformers claim that corporations have been overestimating the return on assets of their corporate defined benefit plans and therefore steadily underfunding their individual plans, which could also stress PBGC's safety net.

Stay Tuned to … proposals for new pension fund rules: As congressional leaders and the U.S. Treasury Department develop specific reform measures, a trial balloon sent up from Federal Reserve researchers reported that the current pension insurance pricing scheme doesn't really account for either company risk or asset risk, and corporate premiums may have to be changed (upward, of course) to reflect the true cost of insurance. Good news short term: PBGC does have a $100 million line of credit with Treasury for short-term needs that has never been used.

President Bush advanced a draft plan to require corporations to apply standard accounting techniques to pension funds and to use current market-set rates to establish a rate of return. (The current approach is to use average rates over a three- or four-year period, which allows for some smoothing of fund earnings.) The real-time, mark-to-market approach, the corporate community responds, would be too harsh and complex and could lead to greater volatility short term.

If more stringent funding or insurance rules were adopted, the short-term result could be a substantial hit on some companies' bottom lines — especially if large "catch-up" payments are required and/or substantial immediate premium increases occur.

(Editor's Note: As this goes to print, congress has just passed apension relief bill that President Bush is expected to sign. The measure would give some companies more than $80 billion in temporary relief for payments to defined benefit pension plans. One provision gives special relief to the airlines and steel companies with weak pension plans. Bush is expected to sign the bill before the April 15th schedule for corporate payments to their plans.)

Corporations argue that they are *not* defaulting on pension obligations and that, in time, fund assets will build to higher levels. Some adjustments are being made: In late 2003, General Electric announced it would cut its modeled rate of return from 9.5 percent to 8.5 percent, equivalent to $500+ million or roughly 2 percent pretax profit.

Treasury Under Secretary Peter Fisher testified before a House of Representatives hearing to sketch out the administration's plan, saying that pension plan beneficiaries are entitled to timely, accurate accounting and disclosure. He established the benchmark estimate that current underfunding of all pension plans covered by PBGC now exceeds $300 billion and that individual and institutional investors need to know the impact of corporate pension fund underfunding on current balance sheets.

The Bush formula could be: Benefit payments to be made in future years should be discounted to today's dollars using rates reflecting the timing of these payments, something done every day in corporate America for other transactions. Corporate pension fund managers would have to transition to 90-day averaging. Corporate fund managers and trustees would also be required to provide greater transparency and accuracy of disclosure to shareholders and beneficiaries. (Note that many retirees fit both categories and would have a keen interest in expanded company disclosures.)

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Stay Tuned to … congressional, PBGC and Bush administration proposals for greater disclosure of pension fund financing and liabilities: These disclosures could affect your company's valuations. Look for increased scrutiny and stepped-up oversight of corporate defined benefit employee pension plans, as well as news headlines proclaiming the vulnerabilities of the current insurance system and potential failure of both company plans and the federal agency insurance scheme. A large pension fund failure would stress PBGC and trigger demands for broad reform, similar to the momentum that built after the Enron and WorldCom financial collapses, leading to the passage of Sarbanes-Oxley in 2002.

In a *Wall Street Journal* op-ed piece last summer, Under Secretary Fisher established the parameters of the debate that IR officers should tune in to: "Americans have been demanding accuracy and transparency in corporate accounting. The Bush administration believes that U.S. pension beneficiaries are every bit as entitled to timely and accurate information as U.S. shareholders."

Stay Tuned to … the growing debate over corporate defined benefit pension plans … and whether to continue retiree health benefits: Both could be important issues this election cycle. And both go straight to the bottom line of most U.S. corporations. IRU

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