WILL DEFINED BENEFIT CORPORATE PLANS "SUNSET"?

The natural process of the aging of the American population, as millions of men and women trek inexorably toward their senior years — and toward some type of retirement or curtailment of work schedule—is raising serious questions about the safety, stability, and future of long-term retirement "safety net" systems. In the spotlight: defined benefit corporate pension plans, which have long been the staple of major U.S. corporations' employee benefits, especially for manufacturing companies. And Social Security for almost all US retirees.

The future prospects for both of these retirement systems are being vigorously debated by stakeholders — including publicly owned corporations with very large financial stakes in the outcome of the debate about needed reforms. Are private pension plans safe and solid? Or are too many corporate plans underfunded and approaching disaster ... with taxpayer bailout needed? What will happen to Social Security in the years just ahead? Will the system "go broke"?

The political and often partisan debate about "privatizing" parts of the venerable Social Security system at times overshadows equally serious questions regarding the financial viability of the corporate pension system as characterized by the underfunding of defined benefit plans. The system under which many of today's workers came to maturity—i.e., *work this many years, earning this much salary, reaching "X" years of age, and we, your employers, promise you "X" dollars a month for the rest ofyour days*—may actually disappear in the near future.

The social contract implied in this approach was spelled out by William H. Whyte in 1956 in his landmark book, *The Organization Man*, a comprehensive study of corporate life in the post-World War II years. Whyte detailed the relentless drive for conformity throughout the American corporation, with the implied promise that you would be taken care of if you bought into "the system."Millions of American employees "bought into" this social contract.

"The Organization men," the former *Fortune* magazine editor observed, "are the ones of our middle class who have left home, spiritually as well as physically, to take the vows of organization life . . . the mind and soul of our great self-perpetuating institutions." How far we have come since then: consider that the American automotive manufacturing industry now has about $60 billion in pension plan underfunding, and the airlines, darling models of conformity in the 1950s, now have $30 billion and more in pension underfunding. All told, pension underfunding at large U.S. companies approached $400 billion at year-end 2004, according federal regulators.

Where will the money come from?

If private sector pension plans collapse, are abandoned, or encounter rough turbulence (as airline industry plans are now experiencing), can current retirees and future beneficiaries count on a public sector bailout? Yes, to a limited extent, but it won't be easy—the financial outlook for the public sector, and especially the federal government, is strained given the effects of recent major events, such as:

- Major hurricanes — Katrina and Rita — struck the Gulf of Mexico coastline, causing hundreds of billions of dollars' worth of damage. Uninsured or underinsured property owners will

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need federal and state assistance to rebuild their communities, create jobs, restore business operations, repair or build housing, and get schools operating again.

- Business disruptions caused by these natural disasters could reduce normal economic activities both short- and long-term, creating lower-than-anticipated revenue flow from personal and corporate taxes.
- The continuing conflict in Iraq and the costs of the U.S. military occupation created the need for continuing supplemental budget approvals well beyond the federal budget forecast for fiscal year 2004-2005.
- Long-term costs for increased "homeland security" measures instituted since the terror attacks of September 11, 2001, can be counted in the hundreds of billions of dollars.
- Long-term debt overhang (and servicing) runs to almost one-fourth of the current federal budget; according to the "National Debt Clock" maintained by Durst Realty in New York's Times Square, the Treasury debt stood at $7.7 trillion dollars in mid-August, averaging $84,000 per American family unit.
- The escalating "off-balance-sheet" debt of the U.S. government, for *real, perceived,* or *implied* guarantees/indebtedness, often in the form of guarantees for government-sponsored enterprises (GSEs), including federal agencies or enterprises insuring consumer mortgages, bank deposits, and defined benefit employee pension funds.

Consider one GSE: The potential financial liabilities for the Pension Benefit Guaranty Corporation (PBGC) — the federal agency providing a safety net for private employee pension plans—are now estimated to be $300 billion or more. This year's operating deficit is escalating with the collapse of airline plans.

In mid-year 2004 in this publication we asked, *"Are U.S. employee pension funds ticking time bombs?"* At the time, the expanding public dialogue on the issue of defined benefit pension funds was heating up, and the answer to our question was not conclusive; we were hearing both "yes" and "no" from the experts.

Over the past year, the dialogue has grown more intense and contentious; several large corporate plans have been taken over by PBGC to ensure that employees receive benefits — and the ticking time bomb question seems to be receiving many more "yes" answers.

Recent headlines in both the popular and business media indicate the change in attitude. Consider the consumer media:

- "Pension Time Bomb — Public on the Line for Billions."
- "Shaky Future for Pensions — Half Underfunded."
- "Unfriendly Skies — Private Pension Plans Hit Turbulence."
- "How Wall Street Wrecked United's Pension."

And the business media:

- "The Pension Mess: How Washington Can Start Cleaning Up."
- "Coffee, Tea ... or Bankruptcy?"

WITH GREATER PUBLIC AWARENESS OF RETIREMENT SYSTEM ISSUES, CHANGES IN PUBLIC OPINION ARE CREATING PRESSURE FOR REFORM OF THE CORPORATE PENSION SYSTEM AND SOCIAL SECURITY.

The attitude toward underfunding is changing

With greater public awareness of retirement system issues, changes in public opinion are creating pressure for reform of the corporate pension system and Social Security. Consider these recent events:

- At mid-year 2005, the non-partisan Government Accountability Office (GAO) told the Finance Committee of the United States Senate that PBGC had a current deficit of $23 billion and that more than 1,100 corporate plans were underfunded by at least $50 million (to meet promised benefit levels). "Too many companies are doing what is legally permissible," testified the head of GAO, David Walker, "rather than what is right when deciding how much money to put into pension plans."
- One important trigger for the increased debate on the future of defined benefit plans was the bankruptcy filing of United Airlines' parent company in 2002; in 2004 the company's $9 billion in pension obligations was shifted to PBGC. (This

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followed the earlier transfer of pension liabilities by US Airways.)

- Shortly after, Delta Airlines and Northwest Airlines filed for bankruptcy protection, raising the possibility of their joining United Airlines and US Airways in shifting pension obligations to U.S. taxpayers. Their combined underfunded pension liabilities exceed $12 billion. Things are so bad, editorialized the *Wall Street Journal*, that Congress should find a way to phase out PBGC liabilities.

Pension fund accounting reforms—looking ahead

The pressure is especially on the Financial Accounting Standards Board (FASB) to add "pension accounting" to its short-term action agenda, reports David Zion, Credit Suisse First Boston (CSFB) research analyst. Mr. Zion expects FASB will soon create a major project on pension accounting, which could be among the most "significant and contentious the Board has tackled in its 32-year history." These are highlights of CSFB's recent accounting bulletin (entitled "Here It Comes") prepared for clients:

- Defined benefit pension plans will receive a good deal more attention in the coming months.
- We should expect significant pension protection reforms to come from Congress. (Note that the Senate is considering "reform" legislation as we go to press.)
- FASB could propose requiring corporations to put their defined benefit pension plan assets and obligations on the balance sheet at fair value (using the mark-to-market approach).
- Such changes in accounting would help create a major shift in corporate attitudes toward pension plans, including shifts in asset allocation, restructuring, plan freezes, or plans being dropped. The concept of defined benefit plans could be heading for permanent sunsetting.
- With $4 trillion invested in defined benefit plans in both private and public employee plans, such changes could have far-reaching macroeconomic implications.

CSFB research outlook. After the bankruptcy protection filing of two major U.S. airlines — Delta, pension underfunding at $5.3 billion; and Northwest, underfunding $3.8 billion — Mr. Zion looked again at the looming crisis in PBGC affairs. (His previous reports include"Pension Reform: It's a Cash Flow Issue," June 2005.) Companies in trouble with their pension plans are also "getting weaker" financially due to mediocre performance by plan assets and growing pension obligations (fueled by lower discount rates).

When FASB and the International Accounting Standards Board (IASB) conduct joint meetings, pension fund reform will be an important agenda item, predicts Mr. Zion; both boards could well launch projects to "fix" pension accounting. The smoothing mechanisms may go and much more transparency may come to pension accounting. Mr. Zion expects an accelerated demise of defined benefit corporate plans (the discussion in Washington over reforms does not apply to public sector employee plans).

Over the past 30 years more than 168,000 pension plans were terminated by American businesses—and yet, defined benefit plans still make up a hefty $4 trillion "industry" with vested interests of all types (the $4 trillion is divided almost in half, between public and private sector plans). Note that 373 of the S&P 500 Index companies still have such plans—with varying impacts on those companies' (1) balance sheets, (2) earnings, and (3) cash flows, Mr. Zion points out. Also, CSFB estimates these S&P index company plans were underfunded by at least $ 165 billion at year-end 2004.

What's wrong with today's pension accounting? The pointed response from Mr. Zion: "[Today's] accounting rules make it look as if the plans are not volatile, when they really are; make the plans appear healthier than they actually are, such as by creating misleading balance sheets and allowing companies to go on long pension funding holidays; make it easy to make [pension] promises; and, rewarding corporate risk-taking without recognizing the risks (thereby transforming some plans into profit centers)."

If companies choose to terminate their plans, there are two paths available: (1) distress termination, with the plan ultimately turned over to PBGC; and (2) standard termination, with a fully or overfunded plan terminated by purchase of annuity contracts from insurance companies or lump sum payments to participants (these are explored in CSFB/Zion report of January 2005,"The Next Savings and Loan Crisis?").

When might FASB move on a major defined benefits plan accounting project? "Don't be surprised if the FASB moves much faster on this issue," advises Mr. Zion. "Assuming the FASB would add the project to its 2005 calendar, a final standard could be issued in late 2007-early 2008." He points to the stock options standard, an agenda item added in March 2003, with the standard issued in December 2004.

Watching the Baby Boom generation. The 77-million-strong gorilla in the debate on retirement finances is the "Baby Boomers" cohort, a unique generation comprised of 77 million men and women living in 42 million households and born between the years 1946 and 1964. "Unique" because the Boomers number more than twice the "Mature" or "Silent Generation" born before them in the years of the Great Depression, who presently make up most of the retiree population. Author Landon Y. Jones detailed the fascinating characteristics of the Boomers in his book *Great Expectations,* and dubbed their effects on society the "pig-in-the-python." Think of a pig swallowed by and moving through a python—the Baby Boomers changed every aspect of American life as they grew older, starting in their infancy; they will eventually have a major effect on retirement funding as well.

The Boomers are found in ample number in many of the corporate and public agency defined benefits retirement programs— moving toward their golden years and the promised retirement check. At the rate of 4 million per year in each of their 18 years (of the generation), they are also edging toward their first Social Security checks. Both realities are shaping the pension reform debate.

As authors J. Walker Smith and Ann Clurman described in their influential book, *Rocking the Ages,* "Baby Boomers are the generational cohort active in the marketplace today that grew up with expectations, life skills and values created by the unbridled economic growth of their formative years. This experience binds the Boomers together. Consumers coming of age in the 1950s through the late 1970s all shared a confidence that progress and prosperity would never stop, and this created the Boomer generation's sense of expectation and entitlement."

The oldest of the babies of the post-World War II years(born in the 1940s)are entering their sixth decade and moving toward some kind of drawdown of their defined benefit plans; the youngest are in their most productive career years (they have entered their 40s) and looking forward to two more decades in the workplace. (Younger workers in "Generation X" or "Y" tell researchers they don't expect to receive a pension plan check when they retire.) Recent surveys indicate that most Baby Boomers cannot completely retire — they typically tell researchers they know they spend too much, save too little, and continue to have high expectations for themselves — and those with corporate or public pension plans are definitely counting on receiving their benefits.

THE 77-MILLION-STRONG GORILLA IN THE DEBATE ON RETIREMENT FINANCES IS THE "BABY BOOMERS" COHORT.

Peter Drucker warned you!

Way back in the mists of ancient times — to be precise, in 1946 as the birth rate began to soar and Peter Drucker published his groundbreaking book, *Concept of the Corporation*—we were forewarned that "paternalism" as found in corporate and union pension plans was not to be counted on for security. The warning was mostly ignored. Said Professor Drucker: "Two attempts have been made to solve the problem of 'industrial citizenship' and both have failed (referring to the efforts of companies and labor unions) and paternalism has become as good as extinct." In referring to ways to create pride in work, he observed, "In the industrial system, [it is not] in giving the worker more Social Security, or more welfare and recreational agencies. It can only lie in giving him the responsibility and dignity of an adult."

This best-selling book — still in print— told the inside story of General Motors, America's largest industrial organization. Fifteen years later, GM was among the first companies to create a defined benefit pen-

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sion plan for employees. Hundreds of other large companies did so in the following decades. Defined benefit plans became one of the most important recruiting tools for attracting bright young men and women to the corporation, and a staple of management-labor contract negotiations.

Fast-forward a half-century and author Drucker again examined the future for corporate and institutional retirement schemes. In *Managing the Next Society,* Mr. Drucker writes: "The proportion of older people in the population is rising steeply. Winning the support of older people will be a political imperative; pensions are already a regular election issue. By 2030, at the latest, the age at which full retirement benefits start will have risen to the mid-70s in all developed countries, and benefits for healthy pensioners will be substantially lower. Everywhere, politicians continue to pretend that they can save the current pension systems." Decision makers are warned again by this great business seer.

There are a number of "realities" that are shaping the pension fund debate that ensure a showdown of some kind over corporate pension accounting. These include:

- Four million men and women are moving toward retirement age each year for 18 years, beginning in 2006-2011 (as those born in 1946 reach ages 60 through 65).
- As the Baby Boomers join the Golden Age cohort, the number of older workers will begin to grow larger than younger, still active workers—putting pressure on Social Security and the current workforce's ability to finance retirement schemes.
- The longer lifespans of Americans mean longer periods of pension fund drawdown after retirement.
- Market returns are lower for assets of corporate pension funds post-2000 market downturn.
- Older Americans are presumed to vote in greater numbers, ensuring that elected officials will speak to their retirement security concerns.

There is some good news on the retirement funding front: CSFB reports that as younger workers flow into the workforce, and Baby Boomers finally begin to put money away, the Federal Reserve Flow Funds data show that defined contribution plans totaled $2.7 trillion in assets at year-end 2004 with another $3.5 trillion stashed in individual retirement accounts (IRAs).

The non-profit National Bureau of Economic Research (NBER) maintains aero-gram on the Economics of Aging" at Harvard University's Kennedy School of Government. In summer 2003, Program Director David A. Wise noted that the combination of economic, labor market, health, and demographic trends points to any number of social and economic challenges in the years ahead. Professor Wise sees a bright spot in the U.S. worker retirement picture: There has been a five-fold increase in retirement plan assets of wage and salary earners since 1975, thanks to voluntary contributions to personal retirement accounts."This," Director Wise notes, "represents a fundamental transition in the composition of post-retirement financial support in the United States." In all of the debate about "pension fund reforms," the importance of self-reliance and voluntary pension contributions should not be overlooked. 401(k) plans, IRAs, and the like could be solutions to the long-term issues surrounding defined benefit plans.

As Congress debates approaches to "save" defined benefit plans, lawmakers could also focus on incentives to get U.S. workers to fund their own pensions to a greater degree. As Professor Drucker noted in 2002, if actual retirement becomes a problem, business enterprises may have to develop ways to hold older, skilled, educated workers in continuing relationships (vs. retiring from the firm). Think of the professor emeritus—millions of corporate emeriti maybe a solution to worker shortages and pension fund program financial shortfalls! •

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