Unlike Death and Taxes, Pensions Are No Longer Guaranteed

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IBM. Verizon. Sears. Hewlett-Packard. Motorola. The list of corporations that have put a halt to guaranteed pension plans comes as a jolt to Baby Boom employees entering what they thought would be their peak pension-building years.

At the same time, new accounting rules and Congressional legislation are being drafted to close the U.S. pension-funding gap, now estimated at $450 billion. While some proposals under discussion could make it easier for companies to discontinue defined-benefit plans, others would create incentives to support investment in defined-contribution programs, such as 401(k) plans, according to Wharton faculty and pension experts.

Olivia Mitchell, director of Wharton's Pension Research Council, says the recent rush to freeze guaranteed pension benefits is a continuation of a long-term trend in abandoning defined-benefit plans in which workers receive a guaranteed retirement payout. The announcements are eye-popping now, she says, because they come from large, well-established companies that seem to be in good health, compared to steel and airline companies that cut pension commitments under severe financial strain. "These are companies that seem viable. They are not going bankrupt and dumping their plans on the government."

While the idea of a guaranteed pension in old age may be comforting, Mitchell says the changing nature of pension plans reflects today's economy, in which little is assured. "There's a common perception that defined-benefit plans are safe and guaranteed and defined-contribution plans are risky, but I think the last 10 years should have removed that misimpression from people's minds. Defined-benefit plans are risky, too."

Changing the game plan for existing employees will generate fallout, predicts Wharton management professor Peter Cappelli, who is also director of Wharton's Center for Human Resources. Older employees hit directly by a pension freeze and younger colleagues who have never been part of a guaranteed plan will question employers' credibility about other areas of compensation, such as bonuses, or what they are told about their career prospects. "If they see pensions get yanked around, what will they think about their ability to rely on other sorts of things companies offer employees? It makes you a little more suspect," says Cappelli. "This might be all right for companies that have a short-term orientation to projects and business plans, but for those that are taking a longer view, it has a spillover effect that is bad."

The traditional defined-benefit plan, in which benefits accrued heavily in the final years of a career, was designed to keep people tied to large employers, like IBM. At that type of company, detailed knowledge of complex internal structures and long-running initiatives was important to the business. "There was not much alternative but to hire really well at the entry level and hang on until the end, because if you dumped your 55-year-olds you couldn't go out and hire 35-year-olds" unfamiliar with the organization, says Cappelli. "Now we have a more open market, which could work well for an individual company. But it really doesn't work well for the whole economy if everybody collectively drops" their more senior workers to hire younger ones.

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A Safety Net with Holes

According to Brigitte Madrian, Wharton professor of business and public policy, the recent move away from guaranteed plans is driven by meager returns in the stock market that have left many defined-benefit plans under-funded for what they have promised to pay out. "The sharp declines in the stock market that happened three or four years ago really made many companies realize exactly how much financial risk they were undertaking by offering a defined-benefit plan," she says. "Many of the recent changes have been motivated by a desire to minimize that kind of financial risk. A 401(k) plan is not without risk, but the risk is born by the employee, not the employer."

Wharton insurance and risk management professor Kent Smetters notes that if a company with a defined benefit plan is driven to bankruptcy, employees will receive only a fraction of their expected pensions from the federal Pension Benefit Guarantee Corp., the nation's pension safety net. The PBGC's own finances are shaky. In 2005, it reported a $22.8 billion deficit in its pension insurance program for single employers like IBM.

A retiree might get only 40 to 50 cents on each dollar of expected retirement income from a pension plan that falls under the control of the PBGC, says Smetters -- and that's if the PBGC itself remains in business. "Right now its liabilities are much higher than its assets. There may be no obligation to pay anything. The idea that the defined-benefit model is somehow more secure is baloney."

Federal law prohibits firms from taking away pension benefits already earned, but companies are free to change their policy for future years at any time. A PBGC survey found that 9.4% of plans had put a so-called freeze on participants' benefit accruals as of 2003, the most recent year for which data are available. The report, the first of its kind, shows that 2.5% of all guaranteed participants were affected by pension freezes as of 2003.

Since then, the number of announcements has been increasing due to two relatively obscure nuances of the pension system, says Mitchell. One has to do with an accounting technique known as "smoothing," in which pension managers can use assumptions about the economy for three to five years in the future to stall reporting a decline in the value of pension assets or an increase in liabilities. "The rules permit a lot of rosy assumptions," notes Mitchell. "So what's happened is that the stock market took a dive in 2000 and interest rates took a dive, too. That combination meant defined-benefit plans became under-funded, but the corporations didn't have to recognize this right away. Now we're at the end of the smoothing period and the chickens are coming home to roost."

The other nuance is that as stock market prices and interest rates picked up slightly at the end of 2005, some funds were able to come closer into balance than they had for several years. That creates an opportunity to close the fund down and cash out before another funding gap arises. Companies that were under-funded a while ago, says Mitchell, "are creeping into full funding territory when they can terminate a plan without getting into big trouble with the government."

To curb pension-fund volatility, the Financial Accounting Standards Board (FASB) is now studying accounting changes that could eliminate smoothing and make pension assets and liabilities a part of the corporate balance sheet. Pension accounting is currently submitted as a footnote to financial reports. The study, which FASB has said it expects to complete by the end of this year, is part of a pension accounting project that was sought by the Securities & Exchange Commission to protect investors and by accountants eager to bring U.S. bookkeeping closer in line with international standards.

Meanwhile, Congress is working to develop new pension legislation this spring that would shore up weak pension funds. Some of the provisions, however, would also make it easier for companies to walk away from pension promises, according to *The Wall Street Journal.* One proposal would reduce the amount of money a worker receives when taking a lump-sum retirement payment -- rather than receiving monthly

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checks after retirement -- by changing the interest rate used to calculate the size of one-time payments.

Another significant change outlined in a House proposal would let poorly funded plans drop one type of benefit already earned, the *Journal* reports. It would allow companies to eliminate early-retirement incentives in so-called multi-employer plans, usually those negotiated by unions with different companies. Early retirement subsidies can add 20% or more to a pension payout.

"The change, if adopted, would reverse a key protection under federal pension law, which forbids employers from rescinding a benefit that has already been earned. But pension advocates worry that modifying a core protection in the law would establish a dangerous precedent that would soon be extended to the majority of pensions," the *Journal* writes.

Stricter accounting and legislation that would force plans into solvency is healthy, says Jeremy Gold, an actuary and pension consultant based in New York, noting that banks, insurance firms and other financial institutions are required to balance their assets and liabilities. But he worries that new pressure to clean up pension-fund accounting may trigger a bigger exodus from defined-benefit plans as companies drop funds that are in strong financial shape to match what their competitors are doing.

"Frankly, I'm concerned. This might be the year when we find out what the future of defined-benefit plans is likely to be," he says. "Until recently I have been optimistic we could work through the problems and end up with better defined-benefit plans than we had before. We may be running out of time.... I would like to see the good defined-benefit plans survive. There is a place in the economy for defined-benefit plans, but I think we have paid too much attention to the weak ones," like those in the airlines, that "have set the tone for an exit from defined-benefit plans."

Investing in Lifestyle Funds

Employees' first line of defense against losing retirement benefits is the PBGC, which oversees the benefits of 44.1 million workers. The agency bails out insolvent funds using premiums earned from healthy plans. Last year it took in premiums of $1.5 billion from 30,300 plans. The PBGC currently charges companies a flat-rate premium of $19 per participant per year. Under-funded pension plans pay an additional variable-rate charge of $9 per $l,000 of unfunded vested benefits. Current proposals in Congress call for an increase of the flat-rate fee to $30.

Madrian says flaws in PBGC's design have left retirees with defined-benefit pensions vulnerable. For example, the flat-rate premium does not encourage companies to manage their pensions better than competitors since all pay the same premium. "In most types of insurance the premiums you pay are tied to the risk you impose. Good drivers pay lower premiums than bad drivers," she says. "With pension insurance premiums, that relationship has been weak at best."

Administration officials are questioning whether a company with a poorly funded pension should be allowed to receive PBGC backing, notes Mitchell. "If you have a corporation with a severely under-funded defined-benefit plan and the corporation is itself in tenuous financial condition, maybe you shouldn't let that company offer any more promises until it cleans up its act. That has the auto company unions upset because they might well fall into that category."

Other legislation is aimed at creating new incentives to encourage investment in defined-contribution programs, such as 401(k) savings plans, which are managed by individuals.

While Smetters argues that defined-benefit plans are no longer realistic for today's mobile workforce, defined-contribution plans have drawbacks too. For example, he says, enrollment in the plans by low-wage workers is between 10% and 25%. "That's unacceptable. It should be 90%." He supports a

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change in the way workers enroll in defined-contribution plans. Now, they must opt in to their company's program, which requires paperwork that many workers choose to ignore. Instead, Smetters says, companies should be allowed to enroll their employees in a plan automatically. The firm could invest the employee contributions, and any matching funds, into a so-called lifestyle fund geared to deliver returns based on a worker's age. If employees want to opt out, the burden is on them.

Employers are reluctant to set up such programs, says Smetters, because they fear they will be sued if the fund's investments don't do well.

Zvi Bodie, a professor of finance at Boston University who also sits on the Wharton Pension Research Council board, says the shift from defined-benefit plans to defined-contribution plans would not be a problem for workers if the level of corporate support remained the same. The IBM policy, set to take effect in 2008, greatly enhances the workers' 401(k) plan. "I don't think that this transition from defined-benefit to defined-contribution is a bad thing at all," says Bodie. "It's unfortunate that it is taking place at the same time that employee compensation is being cut. What's really motivating this is a desire to cut labor costs."

Gold, the pension consultant, suggests that at a company like IBM, senior executives are likely to be exempt from feeling any change in the pension environment because they typically have supplemental pension plans negotiated as part of their individual employment packages. Even those lower down the corporate pension pecking order will remain comfortable. "These people will have smaller pensions than they hoped for, but if you worked for 25 to 30 years for a corporation with a defined-benefit plan, even if you were the wrong age and lost half of your expected pension benefit, those plans were fairly generous," he says. "You might be angry, disappointed and miserable, but you won't be starving."

The speed-up in the demise of defined-benefit plans shifts the bulk of the responsibility for retirement income security to workers, adds Madrian, but government and business should find ways to provide incentives. "It's just been over the last 10 years that people have really started to understand the magnitude that is involved in making sure we get everyone financially well-positioned for retirement."

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