PENSION REFORM

IMPACT ON DEFINED BENEFIT PLANS

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Introduction

In the spring of 2005, the Committee on Investment of Employee Benefit Assets (CIEBA) asked its members – chief investment officers of many of the nations' largest corporate pension plans – to respond to a survey on the impact of proposed changes to rules governing defined benefit pension plans and how these changes could affect pension plans and the workers and retirees in those plans. CIEBA is the voice of the Association for Financial Professionals on employee benefit plan asset management and investment issues.

The survey requested information on the ways plans might change in response to particular policy initiatives. The survey covered some of the changes proposed by the Administration in their pension reform plan (released in January, 2005) and one accounting proposal that continues to be discussed.

Forty-seven (47) senior corporate investment officers responded to the survey. Overall, survey respondents manage $418 billion in defined benefit plan assets on behalf of 5 million plan participants and beneficiaries.

Specifically, the survey asked about possible asset allocation changes and the impact on benefits of the following proposals:

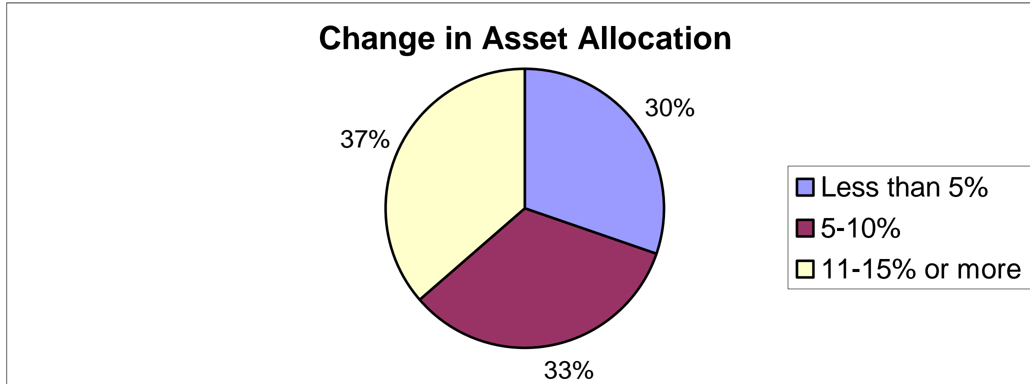
- Use of a discount rate based on a corporate yield curve averaged over 90 days and calculating asset values on a 'mark-to-market' basis.
- Use of a "funding target" of 100 percent; amortization of any underfunding over seven years; and elimination of credit balances.
- Requiring "at-risk" plans – plans whose sponsors have below investment-grade bond ratings – to calculate their liabilities on a termination basis, resulting in much higher required minimum funding.
- Limiting benefit improvements and lump sum distributions for underfunded plans.
- Increasing PBGC premiums.
- Requiring all plans to make contributions at least equal to service/normal cost.
- Changing accounting rules to eliminate smoothing of pension gains and losses and require companies to mark-to-market all pension assets annually for balance sheet and income statement presentation.

Survey Results/Collective Impact of Changes

Investment Policy

The vast majority of survey respondents (83%) indicated that the collective impact of implementing two or more of these proposals would have a significantly greater effect than any single initiative.

Of those who said that the collective impact would be significant, more than two-thirds indicate that they would reduce equity exposure in their portfolios measurably. Thirty-six percent (36%) would reduce their equity holding by 11-15% *or more,* while an additional 1/3 would reduce equity exposure by 5-10%. (Collectively, the asset allocation for CIEBA members is 60% equities, 30% fixed income and 10% alternatives.)



In addition, 70% of all respondents would seek to change the duration of their US bond portfolio, with virtually all increasing their current duration target. Serious questions remain about the ability of the bond market to satisfy increased demand for long-duration investment-grade bonds without market disruption.

More than 90% of those who believed that there would be significant change in their policy asset allocation stated that these changes would take place *over three years or less.*

Effect on Benefits
Sixty percent (60%) of respondents with on-going and/or "open" plans indicate that access to benefits for current and future workers would be curtailed if two or more of the changes described above were adopted. Survey respondents were asked about the likelihood of instituting a 'hard freeze' -- a freeze on future accruals for existing participants or a 'soft' freeze – closing existing plans to new participants. Almost one-third (31%) thought that a 'hard' freeze was "likely" or "very likely" while a similar number (29%) indicated the likelihood of a 'soft' freeze.

Collective Impact on Benefit Structure

	Very Likely	Likely
Freeze future accruals to existing participants	17%	14%
Freeze entry of new participants to defined benefit plans	22%	7%

Survey Results/Individual Proposals

Looking at individual reform proposals, several would have a significant impact on asset allocation policy and benefit delivery on a standalone basis. The three most detrimental proposals are the use of a yield curve and unsmoothed asset values for funding, FASB elimination of smoothing for accounting purposes and the new funding target with a seven-year amortization schedule for underfunded amounts.

Yield Curve
Moving to a yield curve averaged over 90 days and calculating asset values on a mark-to-market basis impacts both asset allocation and benefits. More than half (54%) of respondents would lower their equity exposure, including 16% lowering their equity exposure by more than 15%. In addition, 52% would increase the duration of their U. S. bond portfolio.

This change alone could result in benefit reductions in half of the plans that now are "open" and providing on-going accruals. Thirty percent (30%) think it "very likely" or "likely" that their plans' would institute a 'soft' freeze, while 20% identify the likelihood of a 'hard' freeze.

Accounting Changes
Changing accounting standards to eliminate smoothing of pension gains and losses and require companies to mark-to market all pension assets annually for both the income statement and the balance sheet also has a powerful impact. Almost two-thirds (66%) of respondents would reduce their equity exposure and the same percentage would increase the duration of their bond portfolio.

Benefits provided to workers in "open" plans would be curtailed if this change were adopted. Over half (52%) predict that plans would either freeze accruals for current participants or be closed to new entrants, with the group split almost equally between the two options.

Seven Year Amortization
The proposal to set a 100% funding target and amortize underfunding over seven years does not have as strong an impact as the proposals described above, but its impact is still measurable. Fourteen percent (14%) would lower their equity exposure more than 15% and one-third (32%) would increase the duration of their U. S. bond portfolio.

This change would also have a negative impact on benefits in plans not now frozen. Twelve percent (12%) indicated that freezing accruals to existing participants ('hard freeze') would be "very likely." In addition, 20% said that a 'soft freeze' would be "likely" or "very likely."

Using Credit Ratings to Determine "At-Risk" Status
This proposal did not rank as highly in terms of impact with the survey respondents' group as a whole. However, it is important for plans of sponsors with below investment-grade bond ratings or with investment-grade ratings in the lower range. For this group, this proposal would result in fairly significant portfolio changes and/or benefit reductions.

Twenty-two percent (22%) of this group would expect to lower their equity allocation by more than 15%. More than 60% of this group indicated that some type of benefit reduction was "*very likely*" – almost equally split between 'hard' and 'soft' freezes.'

Conclusion

Defined benefit (DB) plans continue to be an important part of the nation's retirement system covering more than 35 million Americans and their families. Private sector defined benefit plans generally provide universal coverage to workgroups and do not require employees to contribute in order to participate. DB plans are designed to insulate participants from both investment and longevity risks.

As Hewitt Associates pointed out in an earlier CIEBA report, DB plans can provide substantially more benefits per dollar than other savings vehicles, such as defined contribution plans. DB plan assets are invested more effectively and are more diversified, disciplined and stable than assets invested by individuals. According to Hewitt, "DB plans serve as effective, core retirement programs because they both transfer investment risk and generally produce higher, long-term returns."

Defined benefit plans are long-term in nature. Many of the proposals now pending in Congress are short-term oriented. These proposals would have long-term consequences for current and future workers, with the potential to damage the retirement security of millions of Americans.

Plan asset allocation decisions have an important impact on pension plan participants. Shifting plan assets away from equities raises the long-term costs to employers sponsoring defined benefit plans. As this survey demonstrates, such a shift would accelerate the trend to "soft" freezes – closing plans to new entrants and "hard" freezes – freezing benefit accruals for existing participants. 'Soft' freezes are especially hard on younger workers who may never have the opportunity to participate in a retirement plan where they have significant protection from a variety of risks. 'Hard' freezes are especially damaging to mid-career and older workers who are not able to earn benefits during their prime earning years.

As this survey demonstrates, several of these proposals individually could have a negative impact on the future of defined benefit plans. But, the collective impact of two or more of the proposals would be worse. Policy makers need to recognize that in their rush to address today's issues, they may be undermining retirement security for future retirees.