Surviving The Great "Benefits Planning Earthquake" Pension Management in Light of Recent Economic and Corporate Upheavals

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For some years now, there has been a huge crisis developing for companies around how to effectively manage their pension plans. The gist of the crisis is this: Pension plans have lost almost half their value while liabilities have skyrocketed due to the current low interest rate environment. Analysts have attempted to characterize this crisis as a "Perfect Storm," likening it to the hazards described in the book and the movie of the same name. However, a more apt scenario might be that of an earthquake.

If the crisis was merely a "Perfect Storm," pension plan sponsors could simply batten down the hatches and ride it out, hanging on until the resolution of temporary difficulties. However, my view is that this strategy won't work because the landscape of pension plan management has been changed forever by tectonic shifts in economics and policy. As a result, both finance and human resources managers need to be aware of these seismic changes taking shape if they are to effectively guide their firm's pension plans up and over the "fault lines."

TREMORS AND FAULT LINES

The U.S. pension system has proven very resilient to changes in the economy both in macro and micro terms. But structural changes in the past 20 years have made it susceptible to what otherwise would be temporary difficulties.

Initial Fault Line: Shift to 401(k) Savings Plans:*
The first fault line in the current crisis emerged about 20 years ago with the introduction of the 401(k) plan. Before this, companies relied solely on defined benefit (DB) plans, which traditionally provided a fixed annuity payment during retirement. In the 70s and early 80s, the vast majority of workers were covered by DB plans. Now, the majority of workers are covered by defined contribution (DC) plans, primarily 401(k)s.

Compared with DB plans, DC plans shift the investment risk onto employees, with the ultimate benefit paid to workers dependent upon the investment return of the DC fund. With a DB plan, in contrast, the benefit received by participants does not vary with investment return, i.e. the employer must make up any shortfall in future investments. With this shift to 401(k) DC plans, employers in their role as fiduciaries (trustees) became "gatekeepers," deciding what investments participants could choose. This changed the employee/employer relationship vis-à-vis retirement plans and employers didn't realize the full impact of this change until recently.

First Tremor–Declining Interest Rates:
Since the early 90s, interest rates in the U.S. economy have been declining, positive news for most of corporate America since companies can now borrow at lower cost. But for pension plans, this decline has upped the ante of the liabilities in DB plans. Larger liabilities make the plans look poorly funded, adding to the pressure on companies to make cash contributions to their plans. In a normal situation, declining interest rates alone would not be a problem since plan sponsors can plan and budget for these added contributions but in the current reality, this means unplanned for or emergency inputs are continually needed.

Second Tremor– Negative Investment Returns:
After the bull market of the 90s with its unprecedented returns, the market came to a crashing halt in 2000. Since then, the majority of DB plans have experienced three years of

negative returns with some losing more than 40 percent of their value. The combination of this second tremor and the first are what has caused many people in the pension planning industry to refer to the situation as a "perfect storm." Most plans have now lost almost half their value while liabilities spin out of control due to the low interest rate environment.

The Actual Quake– Corporate Downfall:
Yet if all that had happened in the past few years were simply lower interest rates and negative investment returns, we would not be talking here about major disruptions in pension planning. However, the final straw, causing the actual earthquake, has been the many corporate downfalls of recent years. This includes both bankruptcies brought about by corporate malfeasance (Enron) and by economic troubles (airlines) as well as the destruction of trust in the public accounting system.

The Enron collapse, for one, will affect pensions for years to come primarily over the issues relating to fiduciary duty. And the recent collapse of the airline industry as well as other high profile bankruptcies (e.g. Polaroid) have eaten up all the surplus in the Pension Benefit Guaranty Corporation, the U.S. government body set up to insure DB pension plans.

Finally, the public accounting firms have lost the trust of the Securities and Exchange Commission (SEC), the U.S. Congress and the investing public. New, never-seen-before scrutiny is now being placed on accounting practices surrounding pension plans. This triple whammy of fiduciary failure, bankruptcies and accounting problems has been too much. It has pushed out a seismic shock so powerful that the U.S. pension system has since gone down, shaken to its very core.

AFTERSHOCKS AND SURVIVAL TOOLS
Risk Management:
The first aftershock following this earthquake was a realization that rippled throughout the world of the risks associated with DB plans. In the booming 90s, corporate DB plans added to the income that corporations booked. Now, DB plans detract from corporate earnings. This has left management and shareholders alike wondering whether DB plans should stay.

In the past, corporations tolerated these swings in DB plan financials as worthwhile for the purpose of insuring that participants would be paid fixed benefits. The thinking was that corporations could more easily handle the investment risk than could participants. But now, with the short-term pressure from Wall Street, shareholders are asking if they should be expected to shoulder this risk as well as what they actually own when they invest in a company with a larger DB plan. For example, GM's DB plan has more assets than the total market value of GM stock! So, in fact, when you buy a share of GM, you are actually buying an "insurance company" along with a company that makes cars. Is this really what investors and Wall Street want?

With all these developments in mind, some companies have recently taken the drastic step to extricate as much risk as possible from their DB plans. For example, Boots, the large UK pharmacy, has eliminated all equities from its DB assets, investing solely in cash and bonds. Boots made this move to specifically address the concerns of shareholders about the rising risks of DB plans, showing how prevalent the crisis in countries outside the U.S. as well. This move, called "immunization", goes against the long-held belief that companies should invest their assets for the long haul with equity exposure around 60 percent.

Immunization will ensure that Boots will have significantly lower fluctuations in their pension costs. However, the tradeoff for this lower volatility is a higher expected pension cost over the long term. Boots determined that this tradeoff was worthwhile and in the best interests of its shareholders so that now Boots shareholders can own shares of the company and be exposed to the risk inherent in investing in a pharmacy retailer but not be exposed to the risks of running an "insurance company" subsidiary in the form of a DB plan. So if you are managing a company with a DB plan, it may be wise to consider Boots' decision more thoroughly.

INVESTMENT OPTIONS - TOO MANY CHOICES?
Since this pension earthquake was caused by the shift to DC plans in which participating employees make their own investment decisions and thus bare the risk of the investment performance, HR directors have begun allowing them more and more choice. For example, in the early 90s the average number of investment options from which participants could choose was only about six. Now it has more than doubled, with some plans having as many 100 funds available. As you can imagine, HR directors have always felt safe adding more and

more funds, the thinking being that the company's liability is less when participants have more choice.

Now, following the Enron disaster and all its aftershocks, the government agency responsible for pension plans, the Department of Labor (DOL), has taken a very expansive view of the role of the DC plan sponsor. In a brief to the courts during Enron-related litigation, the DOL took the view that plan fiduciaries must (a) inform plan participants of any significant information that could adversely affect their investments, and (b) ensure that all of the plan investment options are prudent.

No longer, for example, will plan sponsors be able to claim that more choice is only good. More choice now means more due diligence and oversight! Both HR and Finance managers need to reassess their due diligence of all their investment choices and plan for continued monitoring.

PENSIONS IN THE SPOTLIGHT

Before the great benefits planning earthquake, the investment community of shareholders and analysts didn't pay much attention at all to pension plans. Pension figures were typically presented in a footnote tacked on to a company's overall financial statement. This footnote contained the balance sheet of the pension plan along with the assumptions used in calculating the liabilities. No one really delved into these assumptions very much, and even analysts admitted they never made any adjustments when comparing two companies with different pension assumptions. The reason they made no adjustments was because they felt the pension plan didn't affect in any way the total valuation of the company.

That's the way it used to be done but not any more! Today everyone is looking at the assumptions used to calculate the liabilities of pension plans. Even the Securities and Exchange Commission is getting into the act. One client of mine received a letter from the SEC asking for additional backup for assumptions presented in their financial statement. Never before in my 15 years as a practicing actuary have any of my clients received such a letter!

A letter from the SEC gets the attention of any CEO. And, if this were not enough, CEOs and CFOs are being asked to defend their pension assumptions during quarterly conference calls with Wall Street analysts. Yes, the days of burying the pension footnote are long gone.

OUTSOURCING

Many, if not most, plans are managed by outside professionals to a large degree. A mutual fund company, for example, may be taking care of the administration and investments for the 401(k) plan at your firm. Managers feel good about letting professionals take care of their complicated plans so that the corporate staff can stay focused on their core skills. In the typical outsourcing model, these outside professionals try to limit their liability by saying they are only following the plan documents and decisions of the fiduciaries. The common term for this is a "directed trustee" but times are changing here too.

During the Enron meltdown, the DOL felt that several outside professionals blindly followed the instructions of Enron fiduciaries to the detriment of plan participants. In litigation, these same professionals have been using the classic defense of "We were only following orders." Yet in today's heavily outsourced environment, these directed trustees are typically the only professionals watching over the operation of the plan, with most company fiduciaries focused on other duties and spending very little time watching over company pension plans.

The DOL sees this as a ripe area for problems - companies wanting to outsource as much as possible while outsourcers hide behind the "directed trustee" label. So, the DOL sent a strong message when it ruled that that directed trustees might not simply follow the instructions of fiduciaries when they know such action would not be in the best interest of plan participants.

What does this mean to today's management teams? One implication is that management should review all its outsourcing contracts and processes. That is, an "administrative audit" on all procedures and documents may be in order. Two, don't be surprised if your outsourcers take a more proactive role in reviewing any instructions you send them. Currently, if directed trustees have questions about an unusual situation, they will ask fiduciaries to sign off explicitly to document their instructions. With new advisories and regulations in place, this by itself may not be enough. Expect your directed trustees to want to discuss such instructions in more detail. A third implication is that top managers today would do well to review and document who exactly is a fiduciary and precisely what authority they have. The DOL is now taking a very expansive view of who is and who is not a fiduciary. Making sure to know who's who and what's what will go a long way toward clarifying the lines of communication.

Finally, many companies may be surprised by the NUMBER of people who are fiduciaries. You should also take this information and compare it against your directors' and officers' insurance. You may be surprised who is and is not covered.

AFTERMATH

The great benefits and pension earthquake has left us with much to sort through, examine and rebuild. That means carefully attending to its ramifications. Just doing the same thing in the same way – riding out the "perfect storm" – will not help a company in today's world survive the new landscape.

Albert Einstein, speaking of other matters decades ago, may have nonetheless aptly described today's pension management scene best when he remarked: "The significant problems we face cannot be solved at the same level of thinking we were at when we created them." Though the ground has stopped moving and the dust has settled, it's now up to each company's management to put things in order. By mapping a course that's right for their company, they can help shareholders and employees together traverse the shambles of what went before on the path toward new ground based on new assumptions. ●

*In 1978, section 401(k) of the United States Internal Revenue Code authorized the use of a new type of deferred compensation retirement savings plan for the benefit of employees of most private firms. Employees who participate in employer-sponsored 401(k) plans choose to defer part of their salary, and the employees themselves determine how much of their salary to defer and how to invest the money.

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