



AMERICAN BENEFITS COUNCIL

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DEFINED BENEFIT PLAN FUNDING: THE EFFECT ON PLANS, PLAN PARTICIPANTS AND JOBS

The recent economic turmoil has touched almost every aspect of our financial lives. One severely affected area has been retirement savings. As we all know, individuals' 401(k) plan and IRA balances have been dramatically reduced. But, as discussed below, the state of defined benefit plans is equally troubling. The unforeseen and nearly unprecedented decline in the market has affected almost all plans. This decline is exacerbated by Treasury's interpretation of the Pension Protection Act as effectively requiring plan assets to be marked to market for funding purposes. Thus, in general, *every dollar* of asset loss must be immediately taken into account. This dire situation could have devastating effects on jobs and the economic recovery.

This document provides (1) aggregate funding data, (2) examples of shocking increases in funding obligations, (3) the effects of this situation on jobs and retirement security, (4) a solution, and (5) an explanation of why our solution needs to be enacted now.

AGGREGATE DATA: DEFINED BENEFIT PLANS HAVE LOST ALMOST A TRILLION DOLLARS

Data from a study published by the Center for Retirement Research at Boston College¹ indicates the following as of October 9, 2008:

- In the 12-month period ending October 9, 2008, equities held by private defined benefit plans lost almost a trillion dollars (\$.9 trillion).

¹ The study is entitled "The Financial Crisis and Private Defined Benefit Plans" (November 2008, Number 8-18) and was written by Alicia H. Munnell (Director of the Center), Jean-Pierre Aubry, and Dan Muldoon.

- For funding purposes, the aggregate funded status of defined benefit plans has fallen from 100% at the end of 2007 to 75% (see footnote 5 of the study).
- More than 50% of private defined benefit plans are less than 80% funded.
- The aggregate contribution that employers will be required to make to such plans for 2009 could almost triple, from just over \$50 billion to almost \$150 billion.

The study goes on to state:

The incidences of underfunding raise the possibility that some companies may not be able to meet their obligations without placing enormous pressure on the firm. This challenge raises the question of firms laying off workers, freezing their pensions, or going bankrupt
[R]equiring firms to increase their funding dramatically just as the economy slips into recession also does not make sense. [Study at 3,5.]

**DISTURBING EXAMPLES:
SHOCKING INCREASES IN FUNDING OBLIGATIONS**

This aggregate data translates into even more disturbing situations for employers and employees.

For example, a Florida company with four defined benefit plans faces an increase in required contributions of more than 2100%, from \$673,000 in 2008 to an estimated \$15,186,000 in 2009. The company’s consultant, Bryan, Pendleton, Swats & McAllister, LLC, states that in light of this increase, “this client, like many others, may be forced to freeze their plans and may have to eliminate jobs to afford those contributions.”

Hewitt Associates provided data with respect to two clients. One company funds to satisfy the funding target transition rule under the Pension Protection Act (“PPA”). That client had budgeted \$36 million in total contributions for 2008-2020. Based on a conservative 25% drop in asset values in 2008, that figure would increase by almost 6000% to \$2.18 billion. A second company funds to avoid the application of the benefit restrictions. For that company, the three-year total of required contributions would increase from \$124 million to \$1.31 billion, an increase of approximately 960%.

Watson Wyatt Worldwide received data from 28 companies indicating that their aggregate required contributions for 2009 will be more than 181% higher than

budgeted. In lieu of the budgeted \$736 million, the companies' required contributions will be approximately \$2.07 billion. Watson Wyatt has also assembled data with respect to the funded percentage of 38 of its clients. For 2008, the plans maintained by the companies had an average funded percentage (for purposes of the benefit restriction rules) of 99.5%. For 2009, the percentage is estimated to decrease to 75.6%.

Buck Consultants studied the effect of the economic situation on six representative plans. Assuming a 25% loss in asset value in 2008, in order to avoid applying the benefit restrictions in 2009, the six companies would need to increase their 2008 contribution by 141%, from \$316 million to \$762 million.

Towers Perrin has provided another example of the devastating effects of the recent economic turmoil. Assuming a 25% reduction in asset value, a plan that was 116.8% funded as of January 1, 2008, will need an estimated \$883 million contribution to be 94% funded as of January 1, 2009 and thus maintain the benefit of the PPA transition rule.

One of Prudential's clients will see its required contribution for 2009 increase from a budgeted \$2.6 million to an estimated \$9 million, an increase of almost 250%. Prudential indicates that this client's experience will be typical.

Aon Consulting reports that a manufacturing company facing tremendous financial pressure will experience a contribution increase from zero to \$100 million. A utility client's contribution will increase from approximately \$100 million to between \$250 and \$350 million. Aon notes that for its clients of all sizes, funding "relief is critical ... for maintaining the plans and surviving tough economic times."

An internal report by the head actuary for defined benefit plan services at MassMutual Financial Group offers an equally chilling outlook:

Our projections are showing DB plans due to get slaughtered in their next round of actuarial valuations. Lest we forget, asset smoothing has all but been eliminated so their unfunded liability will see a \$1 for \$1 increase for their investment losses this year....I haven't heard this consistent level of concern from plan sponsors in 20 years. Just to throw a real example out there. A large [organization] has gone from 114% funded for the 1/1/2008 year down to restricted (i.e., below 80% funded) as of yesterday....You have to assume we'll be doing a lot of freezing amendments next year.

EFFECTS:

LOSS OF JOBS AND RETIREMENT SECURITY

Companies are now making plans and budgets for 2009 and 2010. Unless there is fast and effective action to relieve the shocking funding burdens triggered by the 2008 market decline, there will be three effects.

- There will be extensive job losses across the country. The Business Roundtable sponsored a 2003 study that showed that volatility in the discount rate used to value pension liabilities would have cost 330,000 jobs in 2003. The study was based on the fact that “for each extra dollar of required pension contribution, businesses with defined-benefit pension plans cut back on their investment spending by 60 to 70 cents...Lower investment spending has a multiplier effect on GDP.” In this context, it seems clear that the explosion in required pension contributions for 2009 will cost Americans an enormous number of jobs.
- The decline in business investment and the extensive layoffs caused by the defined benefit plan funding obligations will have a devastating effect on our efforts at an economic recovery.
- It goes without saying that pension plans will be frozen on a scale never before seen. If companies cannot afford the required contributions, they will be forced to cease all future benefits.

THE SOLUTION:

The American Benefits Council has offered a 10-point plan to address the funding crisis and to eliminate pension plan barriers to economic recovery for individuals and businesses alike. This 10-point plan needs to be part of stimulus legislation enacted this month.

WHY DOES THIS HAVE TO BE DONE NOW?

Some have maintained that the funding issues do not have to be addressed now. They contend that because 2009 minimum contributions are not due until September 15, 2010 (for a calendar year plan), legislative action is not needed now or anytime soon. This is incorrect for four important reasons:

- 1) As noted above, because application of the benefit restriction rules would have an extremely adverse effect on employee relations, many companies fund to avoid the application of those rules. To avoid those rules for 2009, most

companies need to raise their January 1, 2009 funded status by making increased 2008 contributions by September 15, 2009 or in some cases by April 1, 2009.

- 2) Also, as noted above, many companies fund to satisfy the funding target transition rule, in order to avoid the adverse cliff effect of failing to satisfy that rule. (See the American Benefits Council's 10-point plan for an explanation of that cliff effect.) Again, to satisfy the transition rule, companies need to increase their January 1, 2009 funded status by making contributions by September 15, 2009.
- 3) If a plan was less than 100% funded as of the valuation date for 2008, quarterly funding contributions are due in 2009 starting April 15, 2009. In many cases, these quarterly contributions will be far greater than was budgeted as recently as two months ago.
- 4) *Most importantly*, companies need to make business plans over a multiple year period. For example, take the case of the company described above that had projected three-year contributions of \$36 million and now faces contributions over the same period of \$2.18 billion. Those types of obligations must be planned for years in advance, not a few months in advance. And for other companies that are not as large, one-year increases in contributions from \$673,000 to \$15,186,000 (as described above) will similarly require immediate drastic action, even if the obligation is not due for another year or two.