tax and financial **ISSUES**

December 2008 | Business drops the ball on pension risk management

Lobbying for Relief

On November 13, 2008, the AICPA news service posted a copy of an open letter from 300 corporations to Charlie Rangel (Democrat-NY), sitting Chairman of the House Ways and Means Committee. This letter requested relief from the full funding provisions of the Pension Protection Act of 2006 because of the unprecedented downturn in the financial markets.

The assertion: *" . . . .the new funding rules will also require huge, countercyclical contributions to their pension plans. Unless the funding rules are modified, they will cause an increase in unemployment and slow economic recovery."*

What's going on here? A little background on pension accounting and funding is needed.

What is an unfunded pension liability?
Many large companies still have defined benefit plans in place. The liability of the company for future benefits is the discounted present value of the benefits that are estimated to be paid. That liability is usually met by transferring money to a pension trust where the assets are maintained for the exclusive benefit of the beneficiaries.

A funding deficiency occurs when the present value of the future pension benefits exceeds the value of the assets in the pension trust.

How are funding deficiencies created?
Companies can lose money and their ability to fund pension benefits can become impaired. The classic examples of these are the steel and airline industries. The pension liability continues to grow as wages are paid, but the company does not make the contributions to remain fully funded.

The pension trust can also have investment earnings that do not keep up with the growth in liabilities. This can happen during period of inflation when the accrual of benefits escalates but investment returns are static. This is something that might happen if a pension trust was invested exclusively in long-term bonds.

The pension trust can also experience declines in asset values during bear markets. This usually occurs when the trust has a significant exposure to stocks, but it can also happen with bonds. During the 1970's as inflation accelerated, it was common to see long-term bonds selling at a significant discount to par value.

How are funding deficiencies eliminated?
The employer must increase contributions to the pension trust, the investment earnings of the trust must exceed the growth in the benefit accruals, or a combination of the two must occur.

Peter M. Rub, CPA

33 N. Dearborn St./Suite 504 • Chicago, Illinois 60602
312/372-2268 • FAX: 312/372-6179 • *www.RubCPA.com*

What happens if the employer is unable to eliminate the funding deficiency and goes bankrupt?
The government has a guarantee program that covers part, but usually not all of the shortfall. The Pension Benefit Guarantee Corp. collects insurance premiums from employers with defined benefit plans. If the PBGC runs out of money because of a series of plan bankruptcies, then the government is the funding source of last resort.

The US government's strategy to minimize its exposure to pension liabilities

When it comes to forking over cash for pension obligation, the pecking order is as follows:

- From the employer
- From the Pension Benefit Guarantee Corp.
- From the government

The steel industry was infamous for granting liberal retirement benefits that could not possibly be paid by the employers in the industry. Eventually these were settled as part of the bankruptcy process. The government had no desire to repeat this process, so laws were enacted requiring a maximum 15 year period for employers to remedy funding deficiencies. The Pension Protection Act of 2006 reduced the amortization period down to 7 years.

What happened in 2008?

- The world economy went into a recession, negatively affecting corporate earnings, and impairing the ability of these businesses to meet their pension obligations out of cash flow

- There was a bear market in stocks, reducing the value of assets in pension trusts.

- Corporate debt securities declined in value as interest rate spreads widened.

- Corporations have not been about to borrow because of problems in the banking sector.

The corporations who have been lobbying for relief from the full funding requirement make all this seem like the perfect storm. However, this seems more like poor risk management rather than a hundred year calamity.

What could have been done to control pension funding risk?

The issue of managing pension liabilities has been around from over 30 years, ever since ERISA was enacted in 1974. It's not like this problem appeared out of deep space. There are a variety of ways that businesses could have acted to limit their funding risk.

Plans could have been terminated years ago. Employers could have fully funded their defined benefit plans and distributed the benefits to the participants.

Employers could have adopted defined contribution plans where there is no residual funding risk. An employer's responsibility to fund a defined contribution plan ends when the contribution for the year is made. If subsequent investment returns are good, bad, or average, the effect falls on the beneficiary.

Employers could have used less leverage, allowing access to credit markets or pension funding out of cash flow. This has been the age of leveraged buyouts. The process even extended down to cyclical businesses. During a recession these businesses with these characteristics have no margin for error:

- High fixed debt service
- Exposure to the economic cycle
- No additional credit capacity

Do you think businesses with these characteristics should be maintaining defined benefit plans where there is significant funding exposure?

Employers could limit investment risk by investing in bonds. An example of this is General Motors' pension plan *(as reported in the NY Times, 11/15/08)*. The plan had a funding surplus as of 12/31/07, and was only 26% invested in stocks. The pension fund appears to be better managed than the auto company.

Action

As a business owner or manager:

- If fluctuations in pension liabilities are too big to manage, then consider terminating defined benefit plans, or converting them into defined contribution plans.

- Consider potential pension funding deficiencies when deciding how much leverage is acceptable in your business.

- Determine how much investment risk is appropriate in the pension trust in determining asset allocation between bonds and other assets.

- Do a better job of overall risk management (not lobby for relief from the full funding standards).

As an investor:

- Consider unfunded pension liabilities when bottom fishing for stocks during a bear market.

- If you have a defined contribution plan or Individual Retirement Account, remember that you bear all the investment risk. Allocate your assets between bonds and other assets accordingly.

(Update 12/12/08: *The U. S. House of Representative and Senate have approved a bill that relaxes the seven year full funding requirement. However, this does nothing to reduce the employer's funding liability. It's only a band aid that affects the timing of payments. The time to deal with risk management is before a bear market occurs.)*