



July 10, 2003

PAGE ONE

Firms Had a Hand In Pension Plight

By ELLEN E. SCHULTZ
Staff Reporter of THE WALL STREET JOURNAL

A lot of big companies call it a looming crisis: They suddenly need to pour millions of dollars into their pension plans, because there isn't enough cash in them to meet the legal requirements. Now Congress is moving to offer companies relief, and the White House is planning a remedy of its own.

But what companies aren't saying is that some of them contributed to the problem themselves. They did so through a variety of strategic moves to plump up earnings or cut costs, at the price of reduced funding for their pension plans.

Over the past decade, U.S. companies have siphoned off billions of dollars in assets from their pension plans. They've used the cash to pay for retirees' health coverage, the costs of laying off workers and even fees to benefits consultants.

Meanwhile, many employers have been putting less money into pension plans in the first place, because they adopted structural changes that made the plans appear better-funded on paper. Converting to a hybrid known as a "cash balance" plan, for example, reduced the sums that companies needed to put into the plans, or even were permitted to.

Hidden in the Arcana

All of these maneuvers were legal, grounded in arcane and little-known provisions of U.S. pension law, and buried in the minutiae of corporate filings. The moves became available to employers thanks to a thriving industry of benefits consultants, which guided companies through the labyrinth to find ways to tap the huge pension surpluses the bull market wrought.

Today, those giant surpluses are mostly gone, thanks in part to a long bear market in stocks and historically low interest rates. Some companies that haven't poured any cash into their pension plans for years face a

legal obligation to do so. They are asking Congress for relief -- new rules that would reduce funding requirements, yet make pension plans appear healthier to both shareholders and the government. They also seek permission to reduce pension payouts to certain departing employees.

One way some companies eroded or reversed their onetime pension surpluses was by tapping the pension assets to pay for staff reductions. **Lucent Technologies Inc.**, the big maker of telecom gear, used about \$800 million in surplus pension assets to pay termination benefits as it cut 54,000 employees from its payroll in 2001 and 2002. The Lucent pension plan, meanwhile, went from having \$5.5 billion more funds in it than legally required on Sept. 30, 2001, to being \$1.7 billion "underfunded" on Sept. 30, 2002.

Retiree Health Costs

Employers have also used pension assets to pay for retirees' medical expenses. Lucent withdrew \$1.2 billion from its pension plan for this purpose between 1999 and the end of 2002. Chemical giant **DuPont Co.** withdrew more than \$1 billion from its U.S. pension plans for retiree medical costs between 1997 and 2000.

A spokeswoman for Lucent says its strategic moves had less impact on pension funding than investment losses and the decline in interest rates. She adds that the pension plan is still healthy. At DuPont, the global benefits director says that the retiree medical benefits went to people who benefit from the pension plan, and that DuPont stopped making such transfers when it no longer had a pension surplus.

Many companies tapped pension assets both for severance and for retirees' health benefits. **SBC Communications Inc.**, the big telephone company, withdrew \$286 million from pension-plan assets in 2001 to pay for retiree health costs. And from 2000 to 2002, while 14,000 SBC employees took voluntary separation, SBC paid them enhanced pension benefits in lieu of cash severance.

"Using these surplus pension assets to pay for retiree medical expenses makes good business sense," says an SBC spokesman. "The retirees' medical benefits paid with the funds from [the pension] are the same retirees that are in the pension plans, so the same group of retirees receives benefits either way."

Since the SBC pension plan had a surplus at the time, "it made sense to use those assets rather than pay out cash severance," says the spokesman. "We did not know then that the market's weakness would continue."

In the 1990s, many employers began offering departing employees their pensions in lump sums instead of monthly payments. Some used this to spur staff reductions, giving workers who weren't planning to retire the option of a lump-sum pension, but only if they left early. But thanks to the abstruse economics of pensions, lump sums could sometimes have the effect of eroding pension funds -- even as they helped companies boost their bottom lines.

Employers say they offered lump-sum pensions to please employees. And indeed, given a choice, employees overwhelmingly choose the lump sums. But companies offered lump sums for a pragmatic reason as well: Doing so cost them less. Although few workers realize it, when an older person at some companies takes a lump sum, the payout costs the employer 10% to 20% less than if the retiree had chosen monthly checks.

This isn't just the normal discount imposed when taking a future stream of income all at once, like a lottery winner who elects cash value rather than annual payments. The pension lump sum totals less than cash value. Thanks to a little-known provision, when an employee voluntarily retires early and chooses a lump-sum

pension, employers can strip out certain early-retirement subsidies the employee would get if he or she took the pension in monthly payments. The subsidies are intended to encourage early departure of workers over age 55.

In these cases, the payout of lump sums can help boost corporate earnings. The employer is paying out less than the liability it had been recording for that employee. So the company is entitled to reverse part of the liability it has already recorded -- resulting in an actuarial gain that helps the bottom line.

But lump sums can lead a pension plan to become less well-funded. That's because employers have been paying out greater lump sums than they have set aside money for.

It has to do with interest rates. Employers must use the 30-year Treasury rate to calculate lump-sum payouts. But many have used a higher interest rate to calculate their current liability for future payouts. This higher rate has the effect of making the current liability lower, and thus reducing a company's need to pour money into the plan.

An employer might have a pension liability of \$500,000 on the books, and might have been contributing to the pension plan as if the liability were \$500,000, yet pay out a lump sum of \$700,000 because of the difference in interest rates, explained David Gustafson, chief policy actuary at the Pension Benefit Guaranty Corp., in recent public presentations.

Also contributing to consumption of pension assets was a step hundreds of large employers took during the 1990s: conversion to cash-balance plans. The move changed the formula for figuring how big a pension an employee would eventually be owed. Instead of the traditional formula -- which multiplies final salary and years of service -- a cash-balance plan gives each employee a theoretical "account balance" that grows by a certain percentage each year.

The change reduced the rate at which many employees' pension entitlements grew, so it cut companies' pension liabilities. Thus, it instantly made the plans look better-funded. That meant that many companies didn't have to contribute as much, or in some cases anything, to their pensions for a period of years.

But the byzantine accounting of cash-balance plans has a striking consequence: They tend gradually to become underfunded. That's because companies calculate their pension liability using an interest rate that makes this liability lower than the sum the company would need to pay the benefits. For instance, a company with a cash-balance plan might credit employees' pension "balances" 3% a year, but calculate its current liability for future payouts using a rate that made the liability appear smaller. That would reduce the company's need to pump money into the plan.

"This would reduce the contribution requirement," says Thomas Lowman, a research actuary with Bolton Offut Donovan Inc., a Baltimore consulting firm. Mr. Lowman says that if the cash-balance pension were terminated, it might not have adequate assets to pay out the promised benefits, because companies would be putting in too little, hoping to make up the difference in investment returns over time.

In the worst case, such a plan might have to be bailed out by the PBGC. So far, this quasi-public agency has taken over fewer than 15 cash-balance plans, a PBGC spokesman says. "That's not to say certain funding methods for cash-balance plans couldn't present difficulties for the PBGC," the spokesman adds, "but those difficulties are speculative at this point since cash-balance plans are a relatively recent phenomenon."

In many cases, conversion of a traditional pension plan to the cash-balance variety initially renders the plan in surplus. That makes it possible for the employer to draw out some pension assets for another corporate purpose. With consultants' help, companies found myriad ways to tap pension surpluses during the late-1990s bull market.

A Plan Withdrawal

Midland Co., a Cincinnati insurer, had a pension plan with a \$6 million surplus at the beginning of 2000. It then gave employees the option of switching out of the pension into a savings plan. If they did, their pension entitlement would no longer grow, but they would begin to accumulate benefits in the savings plan. Many employees took the option.

Because those employees' pensions were no longer growing, Midland was able to reverse part of its pension liability for them. Doing so swelled its income by \$6.8 million.

Meanwhile, Midland withdrew \$3.6 million in pension-plan overfunding, a move a company is allowed to make when it terminates all or a portion of a pension plan. After paying income and excise tax, and transferring a portion to the savings plan as required by law, the company netted \$1.2 million in cash.

The changes left Midland employees with a pension plan that has become increasingly underfunded. Although Midland poured \$3.6 million into the pension plan in 2002, the plan ended the year underfunded by \$4.4 million.

A spokesman for Midland says there are many ways to calculate liabilities, and the way it prefers to do so -- using a measure that excludes future salary increases -- shows that the plan is currently "slightly overfunded."

He adds that withdrawing surplus assets actually made the pension plan better-funded over the long run, because had the assets remained in the plan, they would have lost value over the past three years. "Having withdrawn \$3.6 million from the plan in 2000 and then subsequently contributing \$3.6 million back to the plan in 2002 actually resulted in an increase in the plan's asset value today," the spokesman says.

Changing the Rate

Employers also contributed to today's underfunding by lobbying successfully to ease funding rules a decade ago. Then as now, they fretted that their pension liabilities were made high by a combination of low interest rates and a weak stock market. Congress in 1994 softened funding requirements so company pension plans needed to be funded at only 90% of government-required levels, not 100%.

Voilà: Many companies' underfunded pension plans suddenly appeared better-funded, and the companies were able to pour less cash, or none, into their plans.

And they were able to avoid using the rate on 30-year Treasury bonds to calculate their pension liabilities, which companies have to do when their funding falls below 90%. That T-bond rate was lower than the rates that healthier pension plans could use. This was a disadvantage. A lower rate produces a higher pension liability, because if you assume assets will earn less money over time, you need to set aside more cash today.

Now the 30-year T-bond rate is even lower, and companies want it replaced. It needs replacement anyway, since the U.S. is no longer issuing 30-year bonds. But there's much wrangling on what rate should replace it.

Employers favor a corporate-bond rate -- which, being higher, would make pension plans look better-funded right away. One such proposal is included in a House bill sponsored by Republican Rep. Rob Portman of Ohio and Democrat Benjamin Cardin of Maryland.

The Bush administration is proposing to extend an existing funding-relief provision, set to expire this year, for two more years. This provision lets badly underfunded plans use a corporate-bond rate.

In addition, companies seek extension of a provision that lets them withdraw pension assets to pay for retirees' medical benefits. And they want the right to use more of their own stock when making pension contributions, in lieu of cash.

The only provisions employers seek that would preserve pension assets would work to the detriment of some employees. Employers want Congress to let them change the way they calculate lump-sum pensions, using a rate that would result in smaller payouts. They're seeking, as well, the right to stop offering lump-sum payouts at all if their pension plans become underfunded.

Besides other ways companies have tapped surplus pension assets, they've used some assets to hire the very consultants who taught them how to tap. For instance, Internal Revenue Service filings show that **International Business Machines Corp.** used \$18.4 million of pension assets in 2001 to pay fees to **Watson Wyatt**, a consulting firm that helped it convert to a cash-balance plan. This was seven times the fee Watson Wyatt got when it first began working for IBM in 1995. In comparison, investment-management fees paid out of IBM pension assets declined about 5.5% over the period.

An IBM spokeswoman says the higher fees paid to the consulting firm didn't reflect just its work in converting the pension plan, but also an increase in administrative functions the consultants did for the plan. The fees are "reasonable and necessary," she says.

--Theo Francis contributed to this article.

Write to Ellen Schultz at ellen.schultz@wsj.com¹

URL for this article:

<http://online.wsj.com/article/0,,SB105778944056559900,00.html>

Hyperlinks in this Article:

(1) <mailto:ellen.schultz@wsj.com>

Updated July 10, 2003

Copyright 2003 Dow Jones & Company, Inc. All Rights Reserved

Printing, distribution, and use of this material is governed by your Subscription agreement and Copyright laws.

For information about subscribing go to <http://www.wsj.com>