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Encouraging Excellence

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American Pension Plans: From Capitol Hill to the Board Room

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Agenda

Environment for Change:

- **Defined Benefit Plans**
  - Pension Funding
  - Pension Accounting
  - Asset Management
- **Movement to Defined Contribution Plans**
  - Cost Observations
  - Employer Perspective
  - Employee Perspective
  - Employee Investment Education

Environment for Change

U.S. retirement systems consists of:

- Social Security
  - lowest tier providing roughly $12,000 a year at retirement
- Personal savings
  - highest tier available only to the rich with private investment strategies
- Employer sponsored defined benefit and defined contribution plans
  - more than ½ of all families have at least one member covered by a qualified retirement plan
  - among current retirees, qualified plan benefits are the second source of income trailing Social Security
- Postretirement Medical Programs
  - primarily offered on a pay-as-you-go basis
  - FASB reporting requirements have led companies to cutback employee subsidies

Environment for Change

Employers are faced with the 3 R's:

- Recruiting
  - How do our benefits stack up to the competition?
    - in the 80's and 90's newer, smaller companies were offering 401(k) plans
    - smaller companies grew into bigger companies (Starbucks, Home Depot, etc.)
    - younger, mobile workforce not focused on "retirement" based programs such as Defined Benefit and Postretirement Medical Plans
- Retention
  - How do companies that offer traditional programs transition to meet younger/mobile workforce needs and retain existing employee base?
- Rewards
  - Companies are moving to a "total rewards" strategy
  - Do employees understand value of their benefit packages or focus more on compensation?
  - Do employees understand tax advantages of certain programs?

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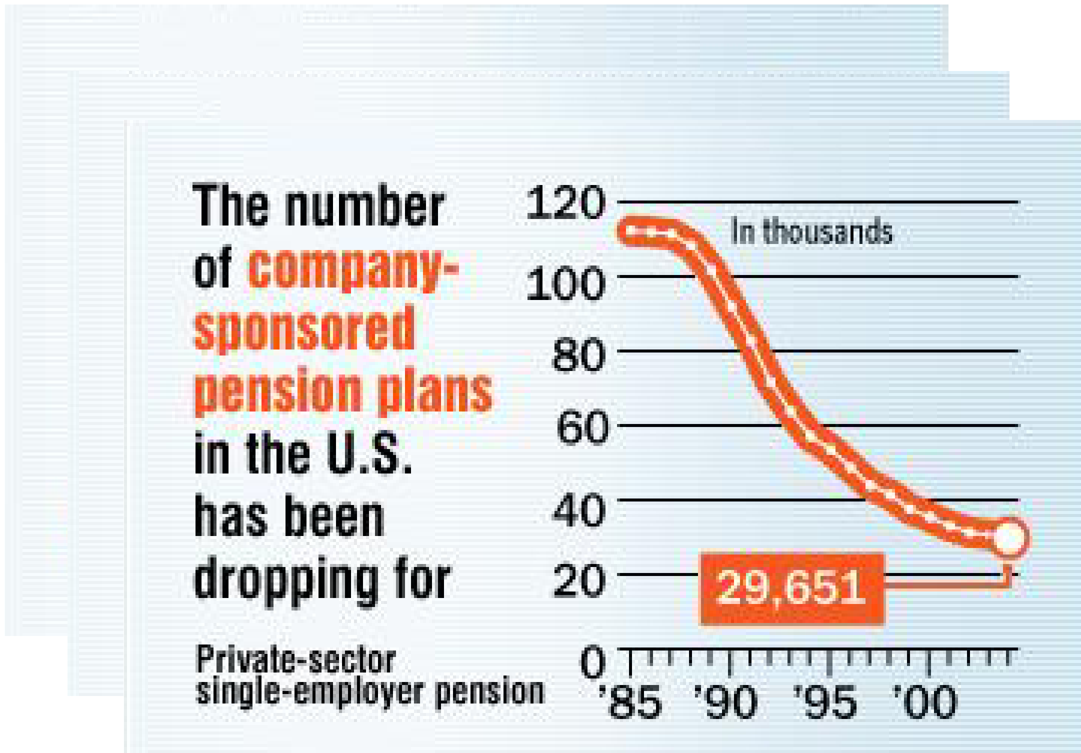
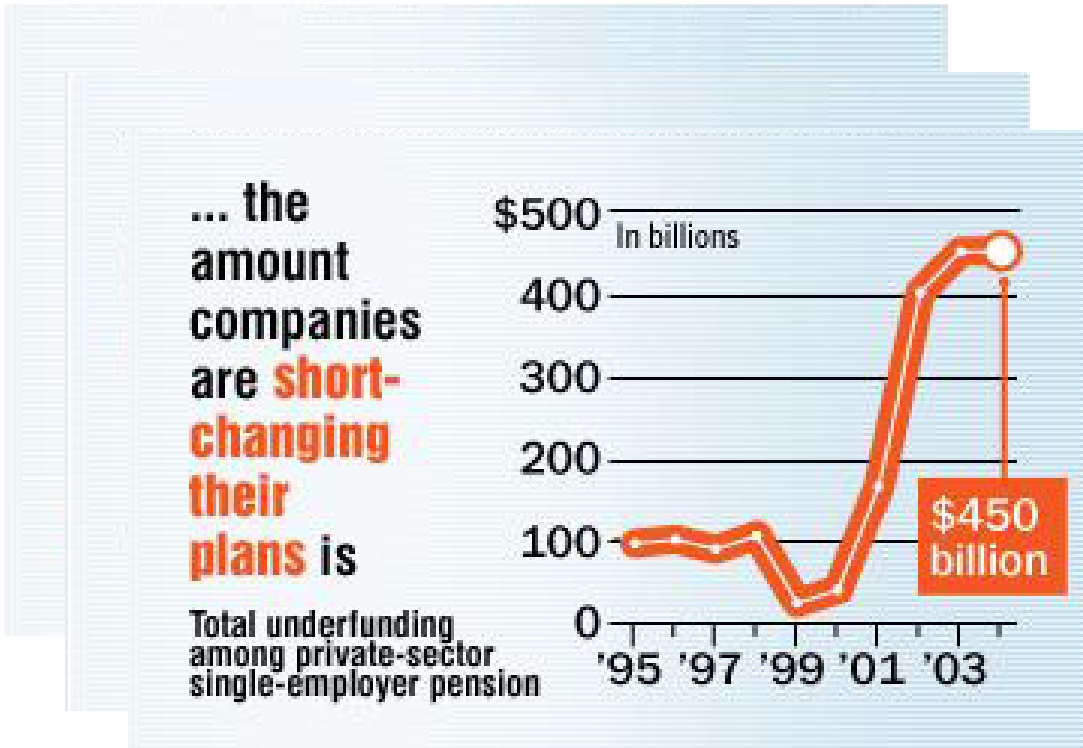
Environment for Change



Source: Pension Benefit Guaranty Corp.

Environment for Change



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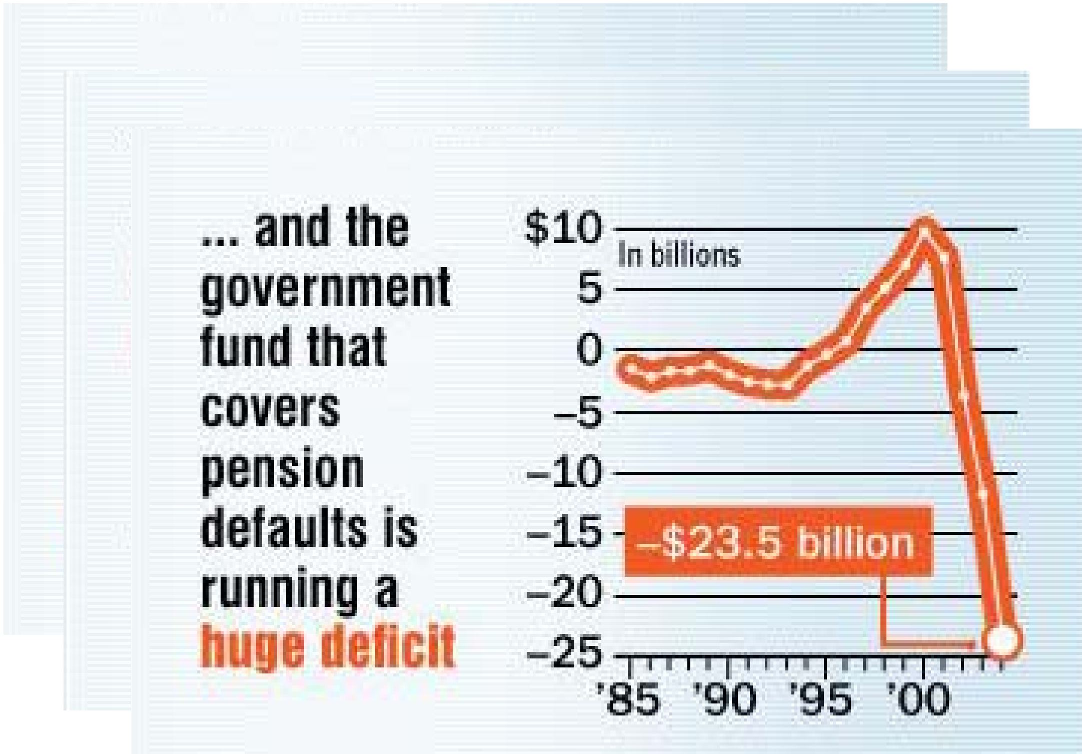
Environment for Change



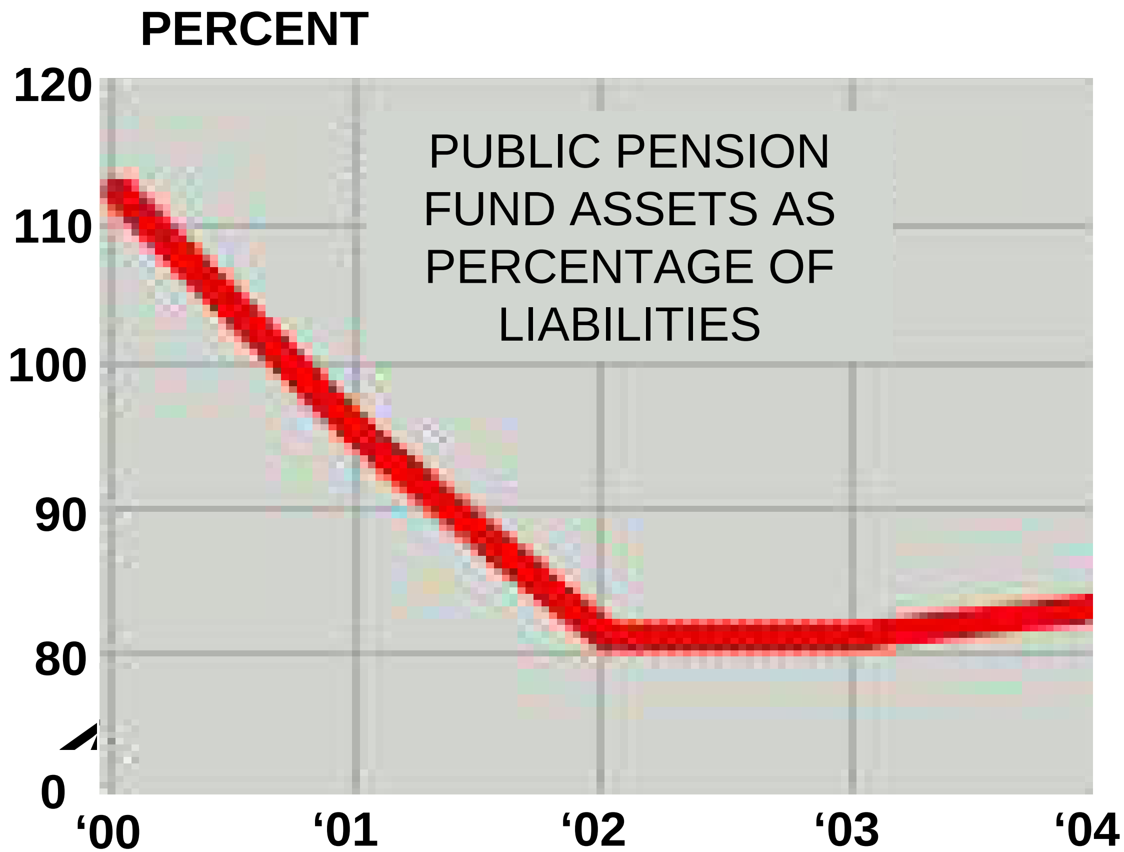
Source: Pension Benefit Guaranty Corp.

Environment for Change

Issues facing Corporate America are also impacting Public Sector Plans

- 125 largest public-pension plans have a deficit over $250 billion
  - poor funding
  - poor stock market returns
  - increased promises for benefits
- Postretirement medical obligations will come under greater scrutiny with new GASB requirements
  - local governments are now realizing extent of future obligations
  - can they modify rich postretirement medical benefits for future employees
- Government sector is faced with hard choices
  - Higher taxes (in NY state, city taxes have increased an average of 20% over a 3-year period)
  - Issue more government bonds ($30 billion in bonds issued over last 10 years)
  - Investment policy changes (more money is being moved to foreign equities and other high-risk markets to improve investment returns)
  - Benefit changes (may be difficult to eliminate perceived promises to employees or move to defined contribution approach)

Environment for Change



Data Source: Wilshire Associates

Defined Benefit Plans – Pension Funding

Rules in effect through 12/31/2005

- Normal Cost
  - cost associated with an additional year of service

PLUS

- Amortization of Unfunded Liability
  - amortized at valuation interest rate assumption
  - different amortization periods depending on event

PLUS

- Additional Funding Charge

LESS

- Credit Balance
  - prior plan contributions in excess of minimum required which can be used to offset future contribution requirements

LESS

- Special credits for overfunded plans
  - Estimated plan assets and liabilities as of EOY
  - Restricted to at least 90% of RPA liability at end of year

Defined Benefit Plans – Pension Funding

Key issues for Corporate Executives

- Large contributions due to Additional Funding Charges
  - required interest rates have dropped
  - asset returns have not rebounded from early losses in 2000-2002
- PBGC premiums
  - Flat rate has increased from $19 to $30 per participant
  - More companies are required to pay variable premiums due to decline in funded status
- Participant Notices
  - Companies that have consecutive AFC and a PBGC variable premium must notify plan participants of plan's funded status
  - In light of recent bankruptcies (ENRON, World Telecom, Airline Industry), employees may react negatively to any notification

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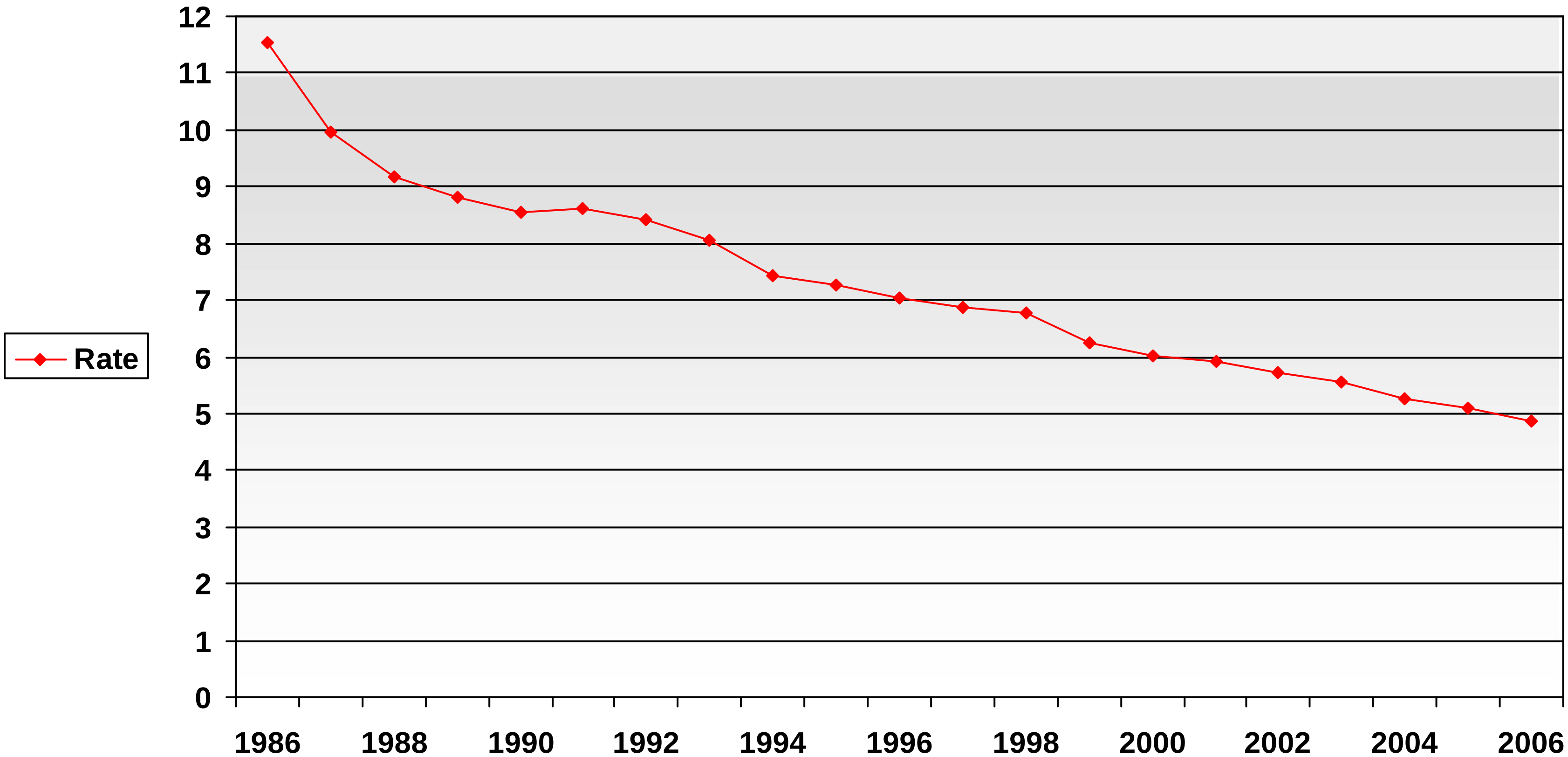
Defined Benefit Plans – Pension Funding

Historical 4-year weighted average of 30-year Treasuries (as of 1/1)



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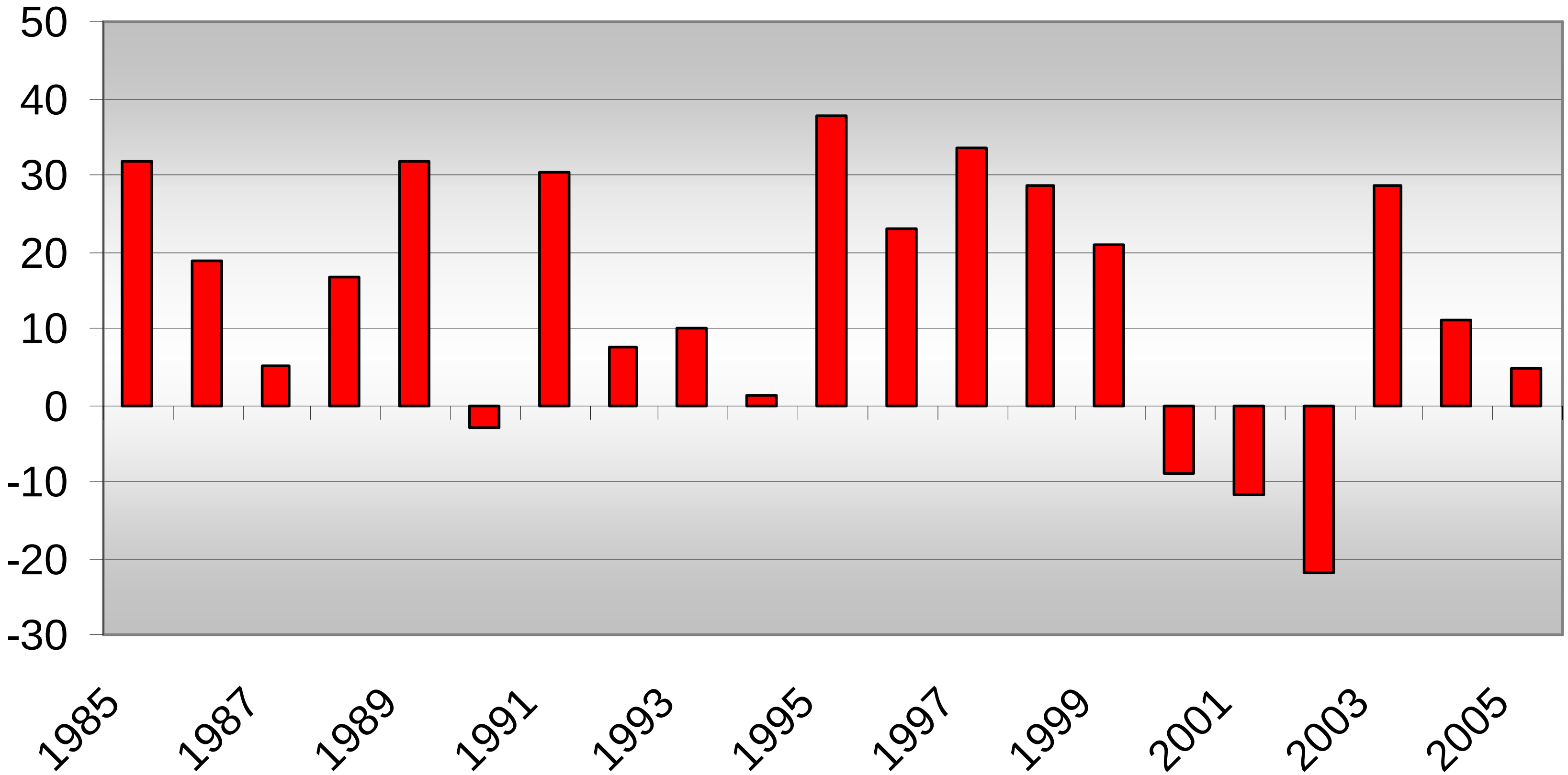
Defined Benefit Plans – Pension Funding

Benchmark annual asset returns (S & P 500)



Defined Benefit Plans – Pension Funding

Executive and Legislative branches are faced with the following dilemma:

- How do we ensure pension plans are adequately funded and reduce the PBGC risk?
- How do we establish funding rules such that annual contributions are not too burdensome to plan sponsors?
- How do we ensure our citizens can afford to retire?

Defined Benefit Plans – Pension Funding

Status of Pension Funding Reform Legislation

- Senate passed the Pension Security and Transparency Act (S 1783) on November 16,2005
- House passed the Pension Protection Act (HR 2830) on December 15, 2005
- Temporary funding relief expired on December 31, 2005
- House-Senate conference committee have been negotiating final bill; preliminary oral agreement reached July 20, 2006
- House approved a sweeping pension bill (HR4) July 28, 2006; along with a minimum wage package (HR5970). Pension bill largely mirrors HR2830. Senate outlook uncertain.

Defined Benefit Plans – Pension Funding

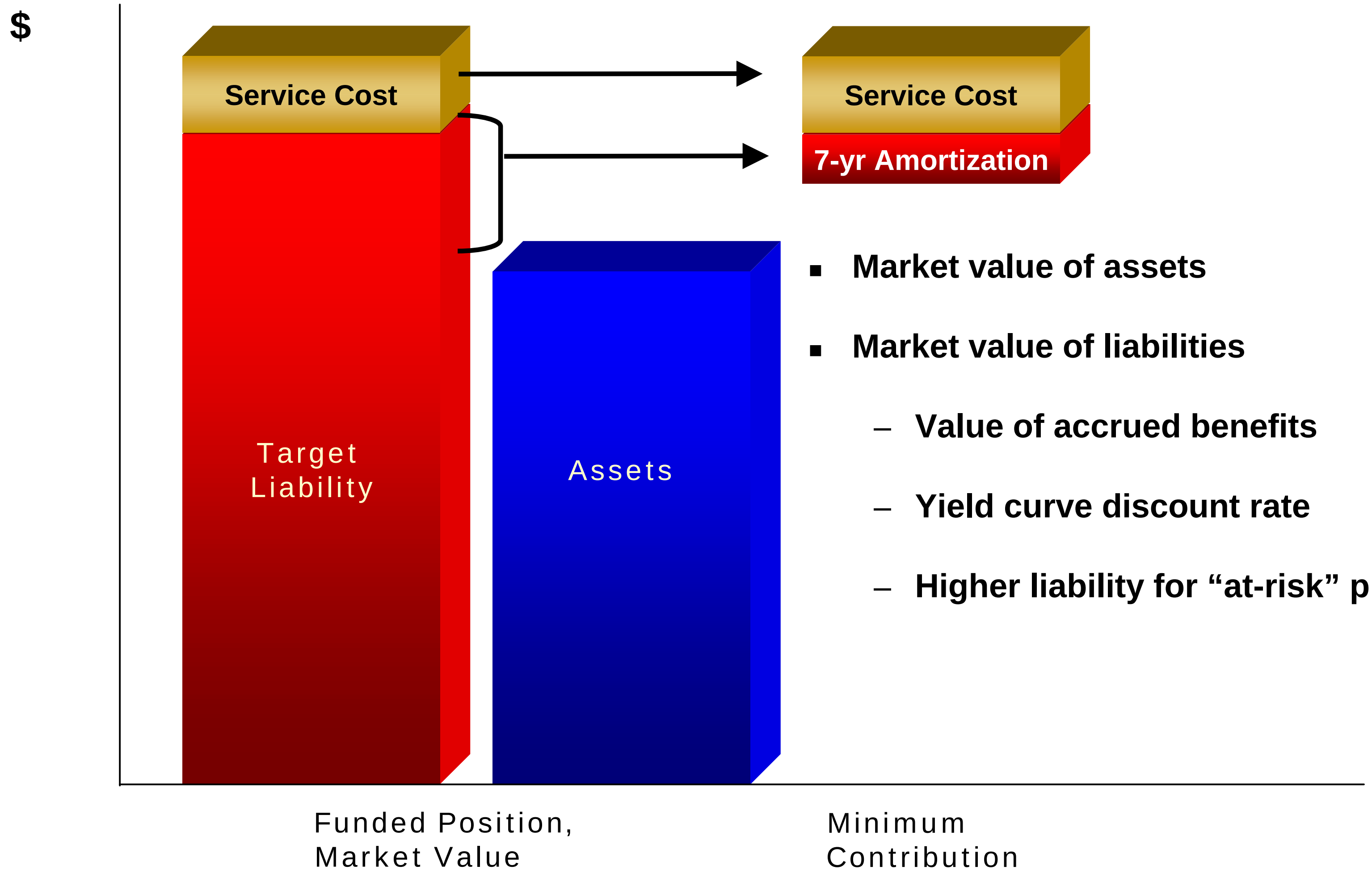
Elements of Final Deal

- 2004 Pension Funding Equity Act's funding relief will be extended for 2006 and 2007 plan years
  - use of 4-year weighted average corporate bond-based discount rate
- Following items will take effect beginning 2008 plan year
  - Funding targets determined as Present Value of Accrued Benefits
    - using a segmented yield curve derived from an unweighted 24 month average yield curve for high-quality corporate bonds
    - using a mandated mortality table
    - 7-year annual amortization of unfunded liability
- 100% funding target will be phased in over 3 years for well-funded plans

Elements of Final Deal: At-risk Plans

- Higher funding target will apply to at-risk plans. At-risk target levels based on most valuable payment date and payment option.
- At-risk assessment (new 70/80 test) equal to MVA – CB compared to ongoing and at-risk target levels.
  - must be at least 80% of ongoing funding target or
  - must be at least 70% of at-risk target
- Credit balances will be subtracted for most calculations and credited with interest based on plan asset performance

Defined Benefit Plans – Pension Funding



- Market value of assets
- Market value of liabilities
  – Value of accrued benefits
  – Yield curve discount rate
  – Higher liability for “at-risk” plan

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Defined Benefit Plans – Pension Accounting Reform Highlights

- Increasing criticism of pension accounting
  - Important information hidden in footnotes
  - Too many smoothing mechanisms
- FASB takes steps to improve accounting
  - Revised FAS 132 disclosure requirements effective late 2003
  - Two-phase project approved last November
  - Phase 1 focuses on balance sheet recognition of funded status
  - Phase 2 reconsiders all aspects of pension and other postretirement benefit accounting, aligning with international standards

Defined Benefit Plans – Pension Accounting Reform Highlights

- Phase 1 key changes Balance sheet recognition of funded status
  - Amounts currently disclosed in footnotes move to balance sheet
  - No new actuarial calculations
  - Applies to retiree medical and other postretirement benefits as well as pensions
  - Retrospective application to earliest reporting period shown in financial statement (balance sheet and income statement)
- Assets and liabilities measured at fiscal year-end
  - Not up to 3 months earlier, as under current rules
  - Two measurements required to effect transition
  - Not retrospective
- Footnote disclosures modified consistent with new reporting

Defined Benefit Plans – Pension Accounting Reform Highlights

Key issues FASB will consider in phase 2

- What is the appropriate balance sheet liability measure?
  - ABO or PBO for pension plans?
  - APBO or something else for retiree medical, other postretirement benefits?
- Should discount rate consider credit rating of the plan sponsor?
- Should the expense calculation
  - use actual return on assets?
  - immediately recognize gains and losses?
  - immediately recognize plan amendments?
- How should the various components of expense be classified?
  - operating expense
  - financing expense

Defined Benefit Plans – Pension Accounting
Reform Highlights - Key milestones

FASB approves two-phase project

Phase 1

Exposure draft released

Exposure draft comment deadline

Revised FAS 87, 106, & 132 released

Revised FAS 87, 106, & 132 effective

2005 | 2006 | 2007 | 2009 - 2010

11/10 | 3/31 | 5/31 | 9/30 | 12/15

Phase 2

Phase 2 timeline developed

Phase 2 effective?

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Defined Benefit Plans – Asset Management
Action to Consider Now

- Determine magnitude of financial adjustments including sensitivity to changes in key assumptions or volatility of asset values
- Review (and modify as necessary, if possible) all programs, policies or agreements that might be affected by a substantial change (in this year of future years) in shareholder equity including compensation programs and loan covenants.
- Determine if changes in investment policy are appropriate to reduce volatility
- Perform a review to determine if assumptions are up to date. With such large potential balance sheet adjustments, auditors may place an even greater emphasis on verifying that assumptions are “best estimate”
- Consider if changes are necessary in the structure of negotiated benefit increases

Defined Benefit Plans – Asset Management
Asset Implications

- When plan sponsors were asked how potential mark-to market accounting rules would impact allocations, it was noted the biggest potential changes would occur in the corporate plan sponsor arena.
  - Fixed Income/Equity Allocation
    - 58% of corporate plans would increase their fixed income allocation and decrease their equity allocations; whereas 79% of public funds would not change their fixed income allocation

Defined Benefit Plans – Asset Management
Asset Implications (continued)

- Fixed Income Duration
  - Only 22% of corporate plan sponsors would increase the duration of the fixed income portfolios; interestingly, 13% of public funds would actually decrease their duration.
- Probability of Terminating or Freezing Plan
  - 30% of corporate plan sponsors would consider terminating or freezing the plan; while only 8% of public plans would consider doing so.
  - Underperforming plans would be more likely to freeze or terminate if mark-to-market was adopted.

Defined Benefit Plans – Asset Management

What Strategies could address or minimize the impact of these issues?

- The goal of pension fund management is to maintain fund assets sufficient to cover benefits and expenses at the lowest possible costs while minimizing future funding volatility.
- All strategies that intend to meet future liabilities must incorporate those liabilities in the strategy.
- Many plan sponsors are looking at the role of fixed income investing in liability based solutions.

Defined Benefit Plans – Asset Management
Role of fixed income

- Over funded plans can have the flexibility to immunize 100% of the pension obligation and invest excess assets in other strategies (equities, high yield, emerging markets) to add value and hedge non-vested portion of active lives with longer horizons.

Defined Benefit Plans – Asset Management
Role of fixed income (continued)

- Fully funded plans can immunize the plan using fixed income with limited use of other asset classes
  - Equities and other longer horizon investments can hedge unvested portions of the active lives and meet unanticipated future cost increases. Because equities can have long periods of underperformance, plan strategies should look for equities to have long horizons and not anticipate having to meet short-or even intermediate term liabilities with equity returns.
  - Benchmark selection is important here. Currently plan sponsors use bond benchmarks that have no relationship to the underlying liabilites. Under this new approach, benchmarks would be directly tied to the duration of the liabilities (i.e. 10 to 15 years depending on the liabilities).

Defined Benefit Plans – Asset Management
Role of fixed income (continued)

- Underfunded plans – there is no easy solution to this situation. Can use bonds to address intermediate term liabilities and minimize volatility but will probably still need an equity component to dig out of the hole.

Movement to Defined Contribution Plans – Cost Observations

- Defined contribution plans were intended to *supplement* defined benefit plans
  - Maximum annual deferral limit is $15,000
- No assurance money will be enough to retire on or will last throughout life expectancy
- Companies could improve their bottom line by moving away from defined benefit plans to defined contribution arrangements
- Although participation in defined contribution plans may be high, poor investments or fund mismanagement has left nearly 25% of all balances less than $5,000

Movement to Defined Contribution Plans – Cost Observations

- Defined benefit and Defined contribution plans allocate company dollars differently
  - Defined benefit plans tend to favor older/longer service employees (employer bears risk)
  - Defined contribution plans tend to favor younger/mobile workforce (employee bears risk)
- Generally, the cost to provide the same amount at retirement will be greater under a defined contribution plan
  - Defined benefit plans weighted toward end of career
  - Defined contribution plans weighted across career of employee
  - Defined benefit plan assets generally earn more than employee investments in defined contribution plan
  - Defined benefit plans are focused on providing retirement income
  - Employees generally do not use defined contribution plans as a retirement benefit rather a tax deferred withdrawal benefit

Movement to Defined Contribution Plans – Employer Perspective

Advantages

Traditional DB Plan	Defined Contribution Plan
▪ Funding and accounting flexibility ▪ Less expensive method to provide retirement benefits ▪ Lower turnover cost ▪ Investment earnings generally higher than DC Plans ▪ Rewards long-service employees ▪ Workforce management	▪ Employee bears investment and mortality risk ▪ No actuarial certification required ▪ Predictable cost ▪ Stable cost ▪ No long-term administrative commitment ▪ Easy to outsource

Disadvantages

Traditional DB Plan	Defined Contribution Plan
▪ Employer bears investment risk ▪ Interest rate risk ▪ Longevity / mortality risk ▪ Volatility of funding and accounting costs ▪ Actuarial certification required ▪ Long-term administrative commitment	▪ Investment earnings generally lower than DB plans ▪ DC plans tend to favor younger / shorter service employees ▪ Inability to manage workforce

Movement to Defined Contribution Plans – Employer Perspective

Advantages

Traditional DB Plan	Defined Contribution Plan
Employer bears investment risk	Portability
Longer service is rewarded	Easy to understand and appreciate
Supports career performance	In-service access (loans, withdrawals)
Guaranteed source of retirement income	Lump sums available
	More control over investment choices

Disadvantages

Traditional DB Plan	Defined Contribution Plan
Lack of portability	Employee bears investment and inflation risk
Difficult to understand	Responsibility for managing retirement assets/investment choices
May not have choice between monthly benefit and lump sum	Indefinite benefits
	Inflation risk
	Risk of outliving assets
	Amount needed at retirement is often underestimated

Movement to Defined Contribution Plans – Employee Investment Education

- The primary reasons for providing plan education are to increase participation (37.5%), increase appreciation for the plan (25.9%), and improve asset allocation (14.6%)[1]
- Types of Education Provided to Accomplish Primary Education Goal:[1]
  - Enrollment kits (64.8%)
  - Fund Performance Sheets (53.7%)
  - Newsletters (43.8%)
  - Internet (39.0%)
  - Seminars (38.0%)

[1]PSCA's 48th Annual Survey of Profit sharing and 401(k) Plans

Movement to Defined Contribution Plans – Employee Investment Education

- Plan sponsors are starting to move beyond education by sponsoring advice programs for their members.
  - The advice trend is fueled by concerns that participants will hold plan sponsors liable for inadequate retirement savings.
  - According to PSCA's 48th Annual Survey, advice is offered in 56.6% of plans. Of plans offering advice, the most common methods of delivery are one-on-one counseling, internet providers, and telephone hotlines.
  - When advice is offered, 27.6% of participants utilize this service.