

## **Market Monitor**

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#### **Pension Reform Passes Congress**

Last week, Congress passed the largest and most comprehensive pension reform legislation in years. The President is expected to sign it soon. The 900 page bill was a long time in the making and contained elements of interest to Defined Contribution (DC) plans such as TIAA-CREF and to Defined Benefit (DB) pension plans. The principal focus of the bill is a series of reforms designed to repair badly broken private sector DB pension plans.<sup>1</sup> In the U.S., private sector DB plans are underfunded by several hundred billion dollars. The Pension Benefit Guaranty Corporation (PBGC), which insures these plans but faces a deficit of \$23 billion, is bracing itself for larger deficits as more firms terminate their underfunded plans and transfer the liabilities to the PBGC.

This week, we concentrate on three themes:

- The systemic nature of problems besetting private sector DB plans
- The reforms to DB plans in the bill passed by Congress
- The investment implications of these reforms

If, as it's been said, a camel looks like an animal designed by a committee then U.S. DB plans look like an animal designed by a committee whose members all spoke different

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<sup>1</sup> The badly broken defined benefit pension plan system in the public sector – state and local government plans – was not covered by the legislation.

languages. The overlapping layers of accounting, regulatory and actuarial rules were impenetrable to pension plan participants and opaque even to regulators and financial analysts. In fact, pension accounting rules (set up to govern these plans) were seen as the poster child for critics of U.S. GAAP (Generally Accepted Accounting Principles) rules, especially in comparison with pension rules in other countries. The confusion created by all these layers provided opportunities for companies to take advantage of legally sanctioned loopholes. The resulting underfunding was most severe in industries affected by globalization or restructuring such as the airline industry.

Last week's Pension Protection Act was designed to strengthen the private DB system by tightening the funding rules and closing the funding deficit at the PBGC. A principal component of the bill was its focus on companies with weak credit ratings below investment grade (BIG). The PBGC noticed that almost all of the terminated plans whose liabilities had been turned over to the PBGC had originated with BIG-rated companies. In most cases, these companies had been low rated for years. The bill requires companies with severely underfunded plans to take a variety of measures to stop the bleeding and hopefully restore the plans to health in order to keep the promises they have made to their workers.

One aspect of the new bill is a requirement that plan sponsors with severely underfunded plans pay higher insurance premiums to the PBGC. Previously, insurance premiums were the same for all plan sponsors and were not priced accurately to reflect differences in the true actuarial cost of the insurance. The second aspect requires almost all companies – with exceptions carved out for a few specific airlines – to bring their plans up to full-funding status within seven years. The third aspect mandates that those companies with severely underfunded plans will now be prohibited from offering any new future benefits.

The fourth aspect requires companies and plan sponsors to discount their liabilities, which are their obligations to pay benefits to workers in the future, at interest rates that accurately reflect when those liabilities will come due. This means that if a plan has relatively young workers and few retirees and hence has

liabilities that are long-term in nature, then it should use long-term interest rates to discount those liabilities. More typical in the U.S. are plans with older workers and many retirees. These older plans have obligations that are coming due soon so should use shorter-term interest rates to discount their liabilities.

On the face of it, these four new requirements to differentiate insurance payments and to fully fund older plans using appropriate interest rates are sensible and long overdue. However, they may have other foreseeable consequences for DB plan sponsors and for the capital markets. One consequence is that in the face of potentially higher costs there may be an acceleration of the trend away from DB plans to DC and cash balance plans as more underfunded pension plans are terminated. This would put more of the decision making about asset allocation and fund selection in the hands of individual workers rather than professional managers. What those individuals will do with that authority remains to be seen.

Another consequence could be changes in the pension plan asset mix. Typically, DB plans in the U.S. had asset allocation strategies that averaged 60% equity and 40% fixed income. This strategy resisted big market swings and

liability changes as many workers aged and retired, leaving them with relatively long-duration assets and increasingly short-duration liabilities. The new legislation will make it very difficult to ignore duration mismatches, and we expect this to affect plan investments as sponsors focus increasingly on asset-liability matching. If the legislation works, this would require a large-scale shift – of hundreds of billions of dollars – from lower-dividend equities that emphasize capital appreciation to shorter-term, income-producing bonds, real estate, high-dividend stocks and some other fixed-income assets. In the case of BIG bonds of firms with underfunded pensions, however, there may be conflicting pressures, as the new full funding requirements put more pressure on their income statements and as the matching requirements encourage investors to seek out more fixed-income assets.

We don't expect either of these effects to appear overnight. The adjustments are likely to be gradual. However, don't be surprised by stories about pension plans shifting away from the traditional 60/40 asset mix to a higher concentration of income-producing assets. And don't be surprised if, in the long run, the new legislation tolls the final bell for the DB plan as we know it.

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with more than \$380 billion in combined assets under management (6/30/06). Further information can be found at [www.tiaa-cref.org](http://www.tiaa-cref.org).

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