



PENSIONS

Bye-Bye Pension

Soon hundreds of corporations may slash pensions by as much as half.

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Flight attendant Vanessa

On a cold Philadelphia day this past February, 50-year-old Janice Winston received something that warmed her considerably: a \$400,000 payment from her former employer, Verizon Communications. The money represented the pension benefits Winston had earned during her 29 years on the job. It was also about \$215,000 more than the company had hoped to pay her.

Joe wants the status quo.
(Photo: Alyson Aliano)

A full seven years earlier, Winston's employer, Bell Atlantic (which later merged with GTE to form Verizon), had made an elegantly simple, barely noticeable change in its pension plan that would have slashed the anticipated retirement benefits not only for Winston but also for thousands of her fellow employees.

What Bell Atlantic (and, for that matter, IBM and some 300 other big companies) had done was to switch its dowdy defined-benefit pension plan to an exciting new type of plan being touted by benefits consultants. Even its name had a dollar-happy ring to it: "cash balance." In the simplest terms, both cash-balance and traditional plans set aside a percentage of an employee's pay every year for a pension. And in both plans the benefit remains "defined"--that is, unlike a 401(k), it can't be slammed by the stock market and is funded wholly by the employer. The difference lies in how that benefit is calculated.

For Winston, a soft-spoken engineer, that new math was going to cause her to lose half her expected nest egg. Hardly the hell-raising type, she didn't organize noisy demonstrations or shout obscenities at management from the building rooftop. Instead, she began a grassroots campaign to force Bell Atlantic to return to the old plan. She sent dozens of e-mails to then-CEO Ivan Seidenberg, hopped into the elevator with him when he happened to visit the Philadelphia office, even flew out to the annual shareholders' meeting in Denver at her own expense to press the issue.

Remarkably, the strategy worked. In early 2000, Bell Atlantic reversed course, allowing thousands of employees to remain in the company's traditional pension plan. And when the company merged with GTE, it even sweetened the plan--hence Janice Winston's big fat payment last month.

It makes a really sweet story. Unfortunately, it's unlikely to repeat itself for millions of other employees. We'll go a step further: Brace yourself for a very un-fairy-tale ending to this story. Millions of American workers are sure to see a large slice of their retirement income go up in smoke. It may not happen right away, but the groundwork is being laid right now. Of course, people have been saying for years (including people at this magazine) that economic necessity--the chasm between the cost of promises made and companies' ability to keep them--leaves management no choice but to reformulate, rethink, and in some cases renege on post-employment benefits for their workers. What's new in the past few months is that they're quietly taking action. The profoundest benefit cuts will happen perhaps a decade or more from now--but you may as well add them to your retirement worry list, alongside those limp 401(k)s, rocketing health-care costs, and underwater stock options (see [Is Your Retirement at Risk?](#)).

To some, especially those brought up in the new economy, pensions may seem like a holdover from the days when people envisioned retirement security as a three-legged stool, in which the first two legs are Social Security and household savings. And to be sure, the share of American workers with company pension plans has progressively slipped in each decade--from almost 40% at the beginning of 1980 to about 20% now.

Still, for those in many giant companies--more than 70% of the FORTUNE 500 --pensions remain a very big deal. From the oil-futures trader at Exxon Mobil to the drug researcher at Eli Lilly, the plans cover 23 million active workers and pay more than \$111 billion each year to another 21 million who are already retired. One way or another, those benefits are going to be sharply curtailed--whether through a cash-balance conversion or other changes we'll discuss in a bit. Warns Dave Hilko, a principal and benefits consultant at Deloitte & Touche: "There's no guarantee on these pension plans any more."

That is not to say that company managements are wholly to blame for the sudden turnaround. As FORTUNE reported in December, the lethal combination of a cratering stock market and plunging interest rates has played havoc with the finances of corporate pension plans. For the first time in years, the plans don't have enough money set aside to pay for the \$1.2 trillion or so in benefits that they owe current and future retirees. The size of the shortfall? Some \$240 billion, or more than half of what they earned in 2002. That shortfall is forcing companies to pour billions of additional dollars into the plans and is whacking billions more off earnings.

Shareholders, to put it mildly, are not content with the status quo. After all, the money going into pension plans is ultimately coming out of their pockets. The stocks of companies with some of the worst pension problems, like General Motors, Ford, Delta, and American Airlines' parent, AMR, have been absolutely pummeled. In executive suites throughout the country, CEOs and CFOs are taking note. "It's not okay to say to shareholders, 'We can fix this over the next ten years,'" says Mike Johnston, who heads the North American retirement practice at benefits consulting firm Hewitt Associates. "Companies have to fix it now."

Of course, the best way out of this mess for everyone involved--

shareholders, companies, and employees alike--would be a nice, sharp rebound in the stock market during the next year or two that just blows away that \$240 billion pension deficit. Whoops--we're back in fairyland again. Credit Suisse First Boston estimates that if big corporate pension plans generate an average return of 10% on their stock market holdings in 2003, they'll still have to pump some \$29 billion into their plans. In 2004, they'll have to shovel in another \$44 billion. (For the record, the S&P 500 is down about 5% this year.)

No, the real salvage work is happening on the liability side of the equation. Translation: Benefits are going to be cut. A lot of companies may even be tempted to just dump their costly defined-benefit plans and replace them with cheaper 401(k)-type alternatives. There's reason to believe it would have happened a long time ago if there hadn't been such compelling tax and accounting reasons for sticking with traditional plans. (More on that later too.)

But first, let's get to the "right now." Many companies are right now lobbying furiously to make a subtle--yet for many employees, potentially damaging--change in their pension plans. It involves tinkering with the interest rates they use to calculate how much they owe workers. To figure out how much money needs to be in its pension plan, a company's financial officers must calculate the present value of its obligations, or what it would cost in today's dollars to make good on the benefits promised to workers when they retire. To determine this minimum funding level, companies factor backward using a so-called discount rate, which by law is tied to the 30-year Treasury bond. Simply put, when the discount rate goes up, the present value of a company's pension obligations shrinks. And that lowers the dollars a company has to put into its pension plan today.

But just as a stock market rebound is no sure thing, companies can hardly count on a sharp increase in interest rates anytime soon. So in an effort to remove this annoying uncertainty, companies are pushing federal lawmakers to let them use higher-than-mandated interest rates--about 1% to 1.5% higher, to be specific--when calculating pension liabilities. If they're successful, it will make a huge difference in the health of their pension plans, at least on paper. According to Ron Gebhardtshauer, a senior pension fellow at the American Academy of Actuaries, each percentage-point increase in interest rates would decrease the pension liabilities of companies by about 10% to 12%. That's no small chunk of change, considering that a slew of large companies are shouldering pension liabilities in excess of \$1 billion.

Permitting companies to increase the discount rate used in determining pension obligations would have a side effect, naturally: It would decrease the amount paid out to workers who take their pension income as lump-sum payments when they retire--by as much as 20% or more, according to Gebhardtshauer--since those payments are also based on the discount rate. Congress, which sets the discount rates that pension plans must use, is expected to make a decision on the issue this year. The word on the Hill is that corporate America will get at least some relief on this front.

But even if employers get their way with discount rates, most observers say that change alone won't be enough to dig many out of the pension

hole. To get out completely, a number of companies are simply going to slash retirement benefits. And it looks as if they're sharpening the axe: According to a survey released in January by Deloitte & Touche, 40% of major pension-plan sponsors are seriously considering cutting the benefits they offer under their traditional plans. What's more, regulations proposed by the Treasury Department in December would make it much easier for them to do so.

The proposed regulations give companies, for the first time in three years, the okay to convert defined-benefit plans to the cash balance version. That's despite the fact that an army of critics has labeled such conversions discriminatory against older workers and in violation of federal pension law. In fact, by late 1999 the plans had generated so much controversy that the Internal Revenue Service, which as part of the Treasury Department determines whether pensions qualify for tax-favored treatment, stopped sanctioning them.

In essence, the new regulations would end the IRS moratorium and make it easier for companies that convert to ward off age-discrimination suits like those launched by the employees of IBM and AT&T. It's no surprise that the proposed regulations have worker groups and others screaming foul. "What we're seeing is a massive assault on the pensions of millions and millions of workers," says Vermont Congressman Bernie Sanders, who along with 216 other Congressmen and Senators sent a letter to President Bush asking him to quash the proposed rule change.

To understand why, a quick review of how pension plans work is in order. Traditional plans are back-loaded--that is, a worker's retirement benefits accrue slowly during his first few years on the job and then increase sharply toward the end of his career. In a typical plan, benefits are based on a formula that incorporates years of service and salary--for instance, an employee may accrue a pension benefit equal to 1.5% multiplied by his years of service, and multiplied again by his average salary during the last five years on the job. So after one year of service, a worker's annual retirement benefit may equal just 1.5% of his salary; after 30 years, that amount may have ratcheted up to 45%.

In cash-balance plans, by contrast, benefits accrue evenly throughout a worker's career. Every year the company contributes a fixed percentage of the employee's salary, say 5%, to a hypothetical retirement account, which in turn earns a hypothetical rate of interest, often tied to the 30-year Treasury rate. Cash balance plans tend to be a big hit with younger employees, because they can rack up retirement benefits much faster than they would under a traditional plan. They're also more favorable to job hoppers, since employees who leave a company can take whatever they've accumulated in their retirement accounts with them, provided they've been with the company for a specified minimum length of time, usually five years. Less than a third of traditional plans offer this feature.

But while cash-balance plans may be highly appealing to younger workers, critics say that when employers convert traditional plans to the cash-balance variety, older workers are hit hard. Here's why: Under a cash balance plan, a 25-year-old and a 60-year-old earning \$60,000 each might get the same \$3,000 pension credit. But that \$3,000 is obviously worth more to the 25-year-old, who will receive 40 years of compounding

returns on the money before reaching normal retirement age, than it is to the 60-year-old, who has only five years left to retirement. And that, say some, flies in the face of the federal law governing defined-benefit plans, which states that the rate of benefit accrual cannot decrease on account of age. "Most cash-balance plans are in violation of the statute," says Norman Stein, a law professor at the University of Alabama who also sits on the Department of Labor's advisory council for employee retirement plans.

There's yet another doozy of a math trick that plays out during a conversion to a cash-balance plan--often it can whack as much as 50% from a worker's expected retirement benefits. When a company makes the switch, it calculates two amounts. The first is the value of the retirement benefit to which the employee would be entitled if he left the company at the time of conversion. That's done by figuring out the present-day, lump-sum value of the pension benefit the worker has already earned, using a discount rate. The lump-sum value for a worker with 20 years' service, for instance, might equal \$100,000.

The second number the company calculates is the employee's "opening account balance" under the new cash-balance plan. That amount is also based on the present value of what an employee has earned to date. But here's the rub: Instead of using a discount rate that's tied to the 30-year Treasury bond, the company can use a rate that's higher--say, by 2%. And as we've noted earlier, the higher the discount rate, the lower the present value of the lump sum. What's more, when companies convert to a cash-balance plan, they also eliminate the early-retirement subsidies offered in most traditional plans, typically to employees aged 50 and older. Those subsidies can add tens of thousands of dollars to the value of a worker's pension. But since they're eliminated under the cash-balance plan, the opening account balance doesn't have to reflect their value.

The net result is that the opening account balance for our hypothetical employee could be far lower than the value of the benefits he's actually earned to date. It might be, say, \$60,000 instead of the \$100,000 he'd get if he walked out the door right then and there. The problem is, if our employee were to stay put, he wouldn't earn any new pension benefits until his opening account balance "caught up" to the \$100,000 he had earned under the old plan. In essence, his pension would be frozen for years to come.

That's exactly what Larry Cutrone, a former tech worker at AT&T, claims happened to him when the company converted its traditional plan to a cash-balance plan in 1998. Cutrone, 55, was downsized from his job in September 2001, and says the conversion has slashed his pension from the \$47,000 a year he had expected to just \$23,000. A Vietnam vet, Cutrone says he feels like "collateral damage." A company spokesperson defends AT&T's cash balance plan as fair.

Not all companies that switch to cash-balance plans do so in a way that harms older workers. In the best-case scenario, firms will offer all employees the choice of staying in the old plan. FedEx told FORTUNE that it intends to convert its traditional plan to the cash-balance version later this year, but the company will offer all employees the option of remaining in the old plan. The company will still save money over the

longer haul, but not as much as it would if it weren't offering the choice. "We wanted to do the right thing by our employees," says spokeswoman Sandra Munoz.

That kind of protection is rare: According to a 2000 study by the government's General Accounting Office, only 9% of companies converting their plans to cash balance offer all employees the choice of remaining in the old plan. About two-thirds offer partial transition benefits that lessen, but do not eliminate, the blow. The GAO study estimates older workers typically experience pension-benefit reductions ranging from 20% to 50% when cash-balance conversions take place.

Under the proposal now before Treasury Secretary John Snow, cash-balance plans would not be deemed age-discriminatory if older workers receive at least the same percentage of pay in their cash-balance accounts each year as younger workers do. In other words, when the conversion takes place, older workers could still find themselves with pensions that are essentially frozen for years to come. And the proposal calls for no requirements to provide employees with transition benefits. Public hearings on the regulations are scheduled for April 9, after which Snow will make a final determination.

Most Capitol Hill observers don't expect the proposed regulations to pass in their current form. That's not just because the Treasury Department fears recriminations from employee groups or Democratic legislators. Companies that want to implement cash-balance plans aren't happy with the regulations either: They feel the proposals are too vague regarding what's considered age-discriminatory. The likely outcome is that Treasury will refine the regulations after the hearings and submit new proposals later this year.

But here's a news flash: It doesn't really matter what Snow decides. Many companies are going ahead with pension plan conversions anyway--and betting the IRS won't disallow them later. The stakes are simply too high to do nothing. Take Delta Air Lines, which in November announced that it is switching its 56,000 non-union workers to a cash-balance system. Workers who retire within the next seven years will be allowed to choose either the old plan or the new one, whichever works out best. According to the company, the switch will result in a savings of about \$500 million during the next five years. "Unless these steps are taken, Delta's retirement expenses would increase at an unsustainable rate," says executive vice president Bob Colman in a press release. Vanessa Joe, a Delta flight attendant for the past 15 years, says she understands why the airline is doing what it's doing but thinks all long-time employees should have the option to stay in the old plan.

Consumer groups, as you'd expect, are crying foul about any substantial changes to employee pensions. "If you've made promises to older workers in their 40s or 50s and they've relied on those promises, it's not fair to change the rules of the game," insists Karen Friedman, a director at the Pension Rights Center, a consumer watchdog group.

Fair or not, though, companies can change the rules of the game virtually anytime they want. That's a central tenet of America's corporate pension system: It's entirely voluntary. By law, a company is obliged only to pay

what its employees have already earned under an existing plan. Cutting future pension benefits is perfectly legal, as long as the cuts apply equally to all plan participants and don't discriminate against older workers.

What's more, if the government forces companies to offer older workers the option of remaining in their traditional pension plans, many businesses will likely pursue alternatives that could leave workers far worse off. For instance, an employer might simply choose to freeze its defined-benefit plan altogether (that is, pay only what workers have earned to date) and replace it with a 401(k), in which employees themselves put up the bulk of the cash. "No company is going to continue with a plan that locks it into heavy liabilities and extreme rules," says Mark Ugoretz, president of the ERISA Industry Committee, a lobbying group that represents big corporate pension payers. "Rather than be saddled with a permanent and costly commitment to maintain the status quo, employers will abandon the system altogether."

Why haven't more companies dumped their old plans already? For starters, during the stock market boom of the late 1990s, big pension plans were overflowing with billions of dollars in surplus assets. Thanks to the arcane rules surrounding pension accounting, companies booked the gains on pension assets into reported earnings--some, like IBM and General Electric, were able to goose annual profits by 9% or more. More important, perhaps, were the tax consequences: If a company had terminated its plan, it would have had to pay a whopping 50% tax on the pension fund's surplus assets.

Today, that pension income has been replaced by pension expense--CSFB estimates that pension losses will subtract \$25 billion in net earnings from the S&P 500 in 2003 alone. So if you can't at least trim your losses, why not drop this unsustainable burden and run?

It's worth noting that it's not unionized employees who are likely to see their pensions slashed. Defined-benefit pension plans are a crucial component of the collective bargaining agreements negotiated between companies and unions--and the latter aren't predisposed to accept cash-balance conversions. "I don't know of any negotiations out there where it's on the table," says Gordon Pavy, a collective bargaining specialist with the AFL-CIO. Indeed, conspicuously absent from Delta's changeover are the airline's 8,000 unionized pilots.

And that has fed into an already increasing tension between union and non-union workers over employee benefits. Janice Winston says that was certainly the case at Bell Atlantic, where unionized employees were excluded from the company's original conversion to the cash-balance plan. "Our argument was that if it's not good enough for the union employees, why is it good enough for us?" she says. In fact, the pension crisis appears to be creating a whole new class of worker advocate. "That's the irony of these abuses," says Friedman. "We've seen a new kind of activist born in this country. They're white-collar, they're highly sophisticated, and once they become activists they don't stop."

No, they may not stop--but that doesn't mean they'll win. In fact, one retirement benefit that's long been considered a given for the baby-boom generation--subsidized early retirement--is almost sure to die off in the

next few years. "Most traditional pension plans have created a labor-market effect that many employers have decided, rightly or wrongly, they no longer want to have," says Dallas Salisbury, president of the Employee Benefits Research Institute in Washington, D.C. "It's the retired-in-place syndrome. You have employees who are 48 years old, they hate their job, they hate the company, but they know they'll cross a magic threshold at 50 or 55." And that threshold is just becoming too expensive to keep in place, say benefit consultants. "We can't afford as a society to continue to pay people to leave a company at age 55," contends Larry Sher, a principal at benefits consulting firm Buck Consultants in New York City. "It can't be sustained."

Deloitte's Hilko offers, however, what may be the single most important message for the millions of baby-boomers lucky enough to still be counting on a lush pension in retirement: "Don't take for granted what you have today."

Additional reporting: Melanie Shanley, Doris Burke

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