TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

THOUGHT CONTAGIONS

Penron II: More Pension Tension

Wednesday, February 27, 2002
Donald Luskin

Once again, a unique, complex and probably crooked **Enron** scheme is pointing toward a problem that exists -- in legal and legitimate form -- elsewhere in corporate America. This time the topic is the adequacy of funding of defined benefit pension plans. It looks like Enron's DB plan may be significantly underfunded, arising from unusual provisions that tied the DB plan to an employee stock ownership plan (ESOP), with a possibly illegal provision that arbitrarily fixed the value assigned to Enron stock. Depending on how all the details play out, the plan may have to get bailed out by the government's **Pension Benefit Guarantee Corporation**. If the PBGC doesn't step in, then plan participants will be left holding the bag.

Last week I wrote about the possibility that Enron-inspired public pressure might force companies to lower the assumed returns used to calculate pension expenses for purposes of GAAP operating earnings (see "Penron? Truth and Hype about 'The Pension Bomb'" February 19, 2002). **General Electric** has already done this, and if enough companies follow suit, S&P 500 operating earnings are going to take a real hit. But whatever happens, it will be only be GAAP optics, not economic reality.

This new Enron development, however, points to an ugly economic reality: what happens to a company's balance sheet, free cash flow, employee relationships and strategic options when its pension plan goes from being fully funded to underfunded, or even from overfunded to less overfunded. It's a systemic issue: the deflation-driven triple-threat of poor equity market performance, low Treasury interest rates, and wide quality spreads in fixed income markets has *reduced* the value of plan *assets* at the same time as it has *increased* the value of plan *liabilities*.

The worst form of that reality is for companies going from funded to underfunded. **General Motors** is the poster child for that reality, and you can see it reflected in the announcement Monday that the company intends to raise $2.5 billion in a convertible bond offering to "rebuild GM's liquidity position, reduce its underfunded pension liability and fund its post-retirement health care obligations." At the same time, GM gaily announced plans to increase production and continue full-speed ahead with aggressive marketing. That, along with a great sense of relief that the company is able to access the capital markets on reasonable terms during tough times, seemed to overcome the grim fact that this already debt-ridden company *had* to access the capital markets in the first place -- and all because its pension plan has come unstuck... *again.*

Investors with memories that stretch back more than a year or two are starkly aware that pension funding troubles are nothing new to GM. For many years GM's pension plan was America's single most underfunded -- and what's so ironic about what's happening now is that it finally managed to achieve full funding for the very first time just last year. It was the culmination of years of cash contributions in the billions, plus what amount to massive direct transfers of shareholder equity into the pension fund in the form of **Electronic Data Systems** and **Hughes Electronics** stock owned by GM. I remember over ten years ago when I used to cover the GM account for **Wells Fargo Investment Advisors** (now **Barclays Global Investors**), GM's head

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

of pension investments confided to me that GM is actually in the business of paying retirement benefits -- it just makes cars because that's the only thing it knows how to do to make the money to pay the benefits.

Well, this is a case of back to the future. In 2001, in a single year, the GM pension plan went from being $1.7 billion *over*funded to $9.1 billion *under*funded. That's a $10.8 billion swing, and *that's* calculated using merciful GAAP conventions that permit all kinds of smoothing and arbitrary choice of critical inputs. But there are far tougher standards than GAAP that a company must use to establish a plan's funded status -- standards set by the **Employee Retirement Income Security Act (ERISA)** and the PBGC. Most companies don't report the details of funded status in relation to *those* standards, but those tougher standards are the ones that determine how much real money a company has to contribute to its plan.

In today's environment of monetary deflation, one particular peculiarity of those tougher standards is wreaking havoc with pension funding status. Specifically, ERISA rules (and parallel **Internal Revenue Service** rules) require that plan liabilities be valued at a discount rate based on the four-year average of yields on 30-year Treasury bonds. Think of this discounted valuation of liabilities as what it would cost the company to shut down the plan and pay all the beneficiaries the present value of all their promised benefits. The lower the rate, the higher the discounted present value of the liabilities -- and so the more pension plans will seem underfunded.

Several years of monetary deflation have lowered the absolute level of 30-year Treasury yields, and this raises the discounted present value of plan liabilities (at the same time as those same deflationary forces have eroded the value of the equity assets in the portfolios designed to fund those liabilities). What's worse, monetary deflation has also opened up a wide gap between long-term Treasury yields and the corporate or annuity rates that more realistically reflect the true present value of plan liabilities if they had to be settled today.

General Motors assumes a 7.3% discount rate for the GAAP calculation of its pension liabilities. The four-year average of the 30-year Treasury yield is something like 6.0%. GM doesn't provide enough detailed actuarial information to calculate the precise impact on their plan's funded status of lowering the discount rate from 7.3% to 6.0%, but reasonable guesses allow me to estimate that this seemingly small change could increase liabilities from the $78 billion disclosed in the 2000 Annual Report to something more like $108 billion -- a $30 billion swing.

If companies start to lower their assumed returns estimates -- like General Electric did -- that would be bad for GAAP optics. But if companies start lowering their discount rates it will be even worse. The assumed return just impacts GAAP pension expenses linearly, one year at a time. But the discount rate impacts these expenses geometrically, compounding over the life of the pension liabilities. I don't think that companies ought to lower their discount rates any more than I think they should lower their assumed returns -- both are generally in line with market conditions. But who knows what they might do?

But whatever companies do or don't do with their GAAP discount rates, Federal law is mandating right now that *far lower* rates be used to calculate funding status under ERISA and PBGC standards. So GM is forced to go deeper into debt and dilution to raise money to cover just a fraction of the problem. If GM doesn't start making down-payments over the next 18 months to close the funding deficiency calculated under these tougher standards, it will have to pay hefty insurance premiums to the PBGC -- set at 0.9% per annum on the underfunded amount. A General Motors spokesman told me that the company planned to make $2 billion in cash contributions to its pension plan in 2003, and that some of that might even be accelerated into 2002.

The international finance and human resources consulting firm **Watson Wyatt** flagged this problem last year, estimating that low long-term Treasury rates might lead to as much as $40 billion dollars in additional employer contributions to DB plans in 2002. This has led the **ERISA Industry Committee (ERIC)**, a Washington-based lobbying organization for corporate retirement interests, to urge Congress to legislate relief. ERIC recommends allowing companies to opt for a fixed 7% discount rate through 2004 while legislators have a chance to sort all this out. A version of this idea was embodied in the economic stimulus bill passed by the **House of Representatives**, but ERIC **vice president Janice Gregory** told me that chances of anything like this passing into law are "not too hot." But she adds that, "Long term, they are going to have to do something." After all, the 30-year Treasury bond specified in the law doesn't even exist any more.

The most obvious victims of this problem are any companies whose pension plans are found to be underfunded under these standards. But even companies with overfunded plans are harmed, to the extent that their overfunded status is reduced. ERISA permits excess plan balances to be used for a variety of carefully constrained -- but nonetheless quite useful -- corporate purposes, especially in merger, acquisition and restructuring contexts.

And Watson Wyatt consultant **William Miner** pointed out to me a subtle way in which the problem affects all companies, and all employees. The same ERISA rules that mandate the use of 30-year Treasury yields to discount liabilities also mandate their use in calculating payments to retirees who choose to take their benefits in the form of a lump-sum payment. With an historically wide gap between Treasury yields and corporate yields or annuity rates, retiring employees have an arbitrage opportunity to take a lump sum calculated using the low Treasury yield, and then turn around and buy an annuity based on a far higher rate.

Think through the game theory of this arbitrage. From the employee's standpoint, the smart thing to do is take the lump sum instead of the benefits over time, thus taking more out of the pension plan than the amount to which he is arguably entitled considering the true costs of funding his post-retirement benefits, leaving the company to make up the difference in the future. Or a really smart employee might decide to retire early and grab that artificially high lump-sum payment while it's still available. From the company's standpoint, the smartest thing to do would be to simply shut down the whole plan. That way the company could buy annuities for beneficiaries at the higher rates, rather than letter the retirees buy them, turning the arbitrage back to its own advantage.

After today's new Enron revelations, the chances of getting this problem fixed anytime soon have fallen to near zero. Lawmakers will have little interest in doing anything that might be seen as making funding requirements more liberal.

But just because the problem won't be solved, don't think that it won't be talked about. You're going to be hearing a lot more about pensions now. Yes, this new wrinkle in the Enron saga should come as a rude shock to politicians like **Senator Joe Lieberman** and pundits like **Paul Krugman** who had seized on problems in Enron's 401(k) plan as reason to return to a world in which paternalistic corporations take care of employees' pension needs from assembly line to grave, removing in the process any investment choices from the employee (see "What Enron's Collapse *Doesn't* Mean" December 4, 2001; and "Power to the People", December 5, 2001). Well, this shows that you can take away people's investment *choice*, but you can't take away their investment *risk*.

But at this point Enron's 401(k) problems are down the memory hole, and now the harsh and indiscriminate light of Enronic Cleansing will be shined on any company with an underfunded pension plan. Hey, why stop there? Let's take a close look at *all* companies that have *any* kind

of pension plan at all! And while we're at it, how about those unfunded post-retirement health-care liabilities?

There's nothing that anyone will see under that harsh light that's going to be good for equity valuations. TM