Hewitt

Testimony
on Behalf of Hewitt Associates LLC

By Richard Jones
Chief Retirement Actuary

Before

U.S. Senate

Committee on Health, Education, Labor, and Pensions

Hearing on

Pensions in Peril: Helping Workers Preserve Retirement Security Through a Recession

October 29, 2009

Hewitt Offices—U.S.

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About Hewitt Associates

Hewitt Associates (NYSE: HEW) provides leading organizations around the world with expert human resources consulting and outsourcing solutions to help them anticipate and solve their most complex benefits, talent, and related financial challenges. Hewitt consults with companies to design and implement a wide range of human resources, retirement, investment management, health management, compensation, and talent management strategies. As a leading outsourcing provider, Hewitt administers health care, retirement, payroll, and other HR programs to millions of employees, their families, and retirees. With a history of exceptional client service since 1940, Hewitt has offices in over 30 countries and employs approximately 23,000 associates who are helping make the world a better place to work. For more information, please visit www.hewitt.com.

Chairman Harkin, Ranking Member Enzi, and Members of the Committee:

I am extremely grateful for the opportunity to appear before you today to provide testimony to the Committee as it examines how best to ensure that American workers can preserve their retirement security in harsh economic times. Pension funding is one of the most critical challenges currently facing employers, and the eventual solutions will have a significant impact on the continued prosperity of millions of American workers.

My name is Richard Jones and I serve as the Chief Actuary for Hewitt's Retirement Consulting Practice. Hewitt Associates is a global human resources outsourcing and consulting company providing services to major employers in more than 30 countries. We employ 23,000 associates worldwide. Headquartered in Lincolnshire, Illinois, we serve more than 2,000 U.S. employers from offices in 18 states, including many of the states represented by the members of this distinguished Committee.

As a global leader in integrated retirement solutions, Hewitt Associates has extensive experience supporting clients in pension plan design, finance, and administration for mid- to large-sized employers. We advise more than 2,500 clients on more than 3,500 pension plans and administer defined benefit plans for more than 385 clients. In total, our clients represent more than 10 million plan participants.

To avoid some of the perils that the Committee is addressing today, my testimony will focus on the public policy need for greater flexibility in defined benefit financing and management. Our experience and data show that defined benefit plans, coupled with defined contribution plans, have generally been effective at producing reliable retirement security for covered Americans. However, many defined benefit plans are now in jeopardy due to a struggling economy and to regulatory changes that limit the flexibility of how and when companies fund their plans. The imminent need is for temporary relief to help employers solve the funding problems exacerbated by the recession. Longer term, we believe that future pension plans will have to be designed differently so as to incorporate third-party risk sharing, which would give participants more security while allowing employers and workers to assume a manageable amount of risk.

The need for this risk-sharing model is evidenced by the recent examples of employees losing significant portions of their pension savings after their employer had to file for bankruptcy. Future models must guard against this possibility on the front end, because we cannot afford limitless bankruptcy protection. The future of retirement income in corporate America requires employers to offer both defined benefit and defined contribution plans. To do this, we need to reinvent defined benefit plans so that they are more flexible and allow both companies and employees to better manage and diversify risks.

I. Perils in the Current Environment

The last 15 years have brought monumental changes to the pension landscape. Retirement plan designs and mix have shifted in response to economic and regulatory changes and to employee needs. As the risks to employers have grown, companies have increasingly chosen to close or freeze their plans. Unless additional support is provided to assist with pension funding needs aggravated by the current recession, this trend is expected to continue. In the U.S., approximately 25 percent of the *Fortune 500* plans are frozen, and some studies show that this could increase to 60 percent or 70 percent by 2012.[1] We believe the "survival" actions being taken by companies today—pension plan freezes and cutbacks, and similar actions in 401(k) and other defined contribution plans—are contributing to a retirement savings gap that is already

[1] McKinsey & Company, "The Coming Shakeout in the Defined Benefit Market, " (2007).

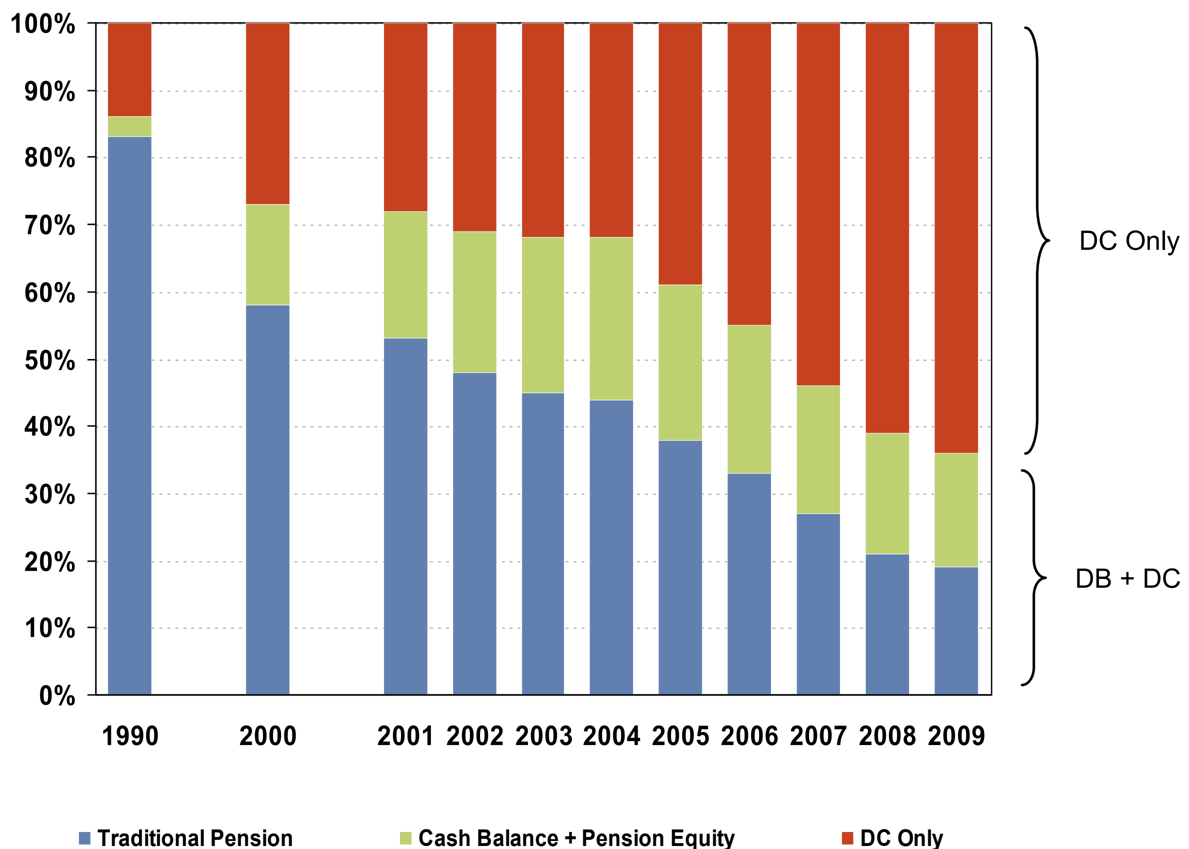
very difficult for many American workers to replace. But policymakers and employers can take steps now to improve the outlook for retirement plans as we await a full-blown economic recovery.

Retirement Plan Design

As pension issues have become more complex, employers have increasingly shifted from defined benefit pension plans to defined contribution plans. This move partly reflects workforce needs and preferences, as well as the huge financial exposure created by defined benefit plans. But our experience also tells us that another key driver has been increasing regulatory requirements and the recognition of the financial exposure created by defined benefit pension plans. Recent regulatory changes, including more stringent FASB/SEC requirements, as well as adoption of the Pension Protection Act of 2006 (PPA), have advanced the "mark-to-market" requirements of retirement plan financing and unfortunately have intensified the shift away from defined benefit pensions.

Exhibit 1 illustrates the movement away from defined benefit pensions among large U.S. employers in the last 20 years.[2] Whereas defined benefit plans were the predominant form of retirement plans in 1990, the tables have now turned, with defined contribution plans becoming the prevailing plan. This trend will continue unless steps are taken to dampen the volatility or otherwise soften the blow of defined benefit financing.

Exhibit 1: Changes in Prevalence of Retirement Plan Types Among Large U.S. Employers



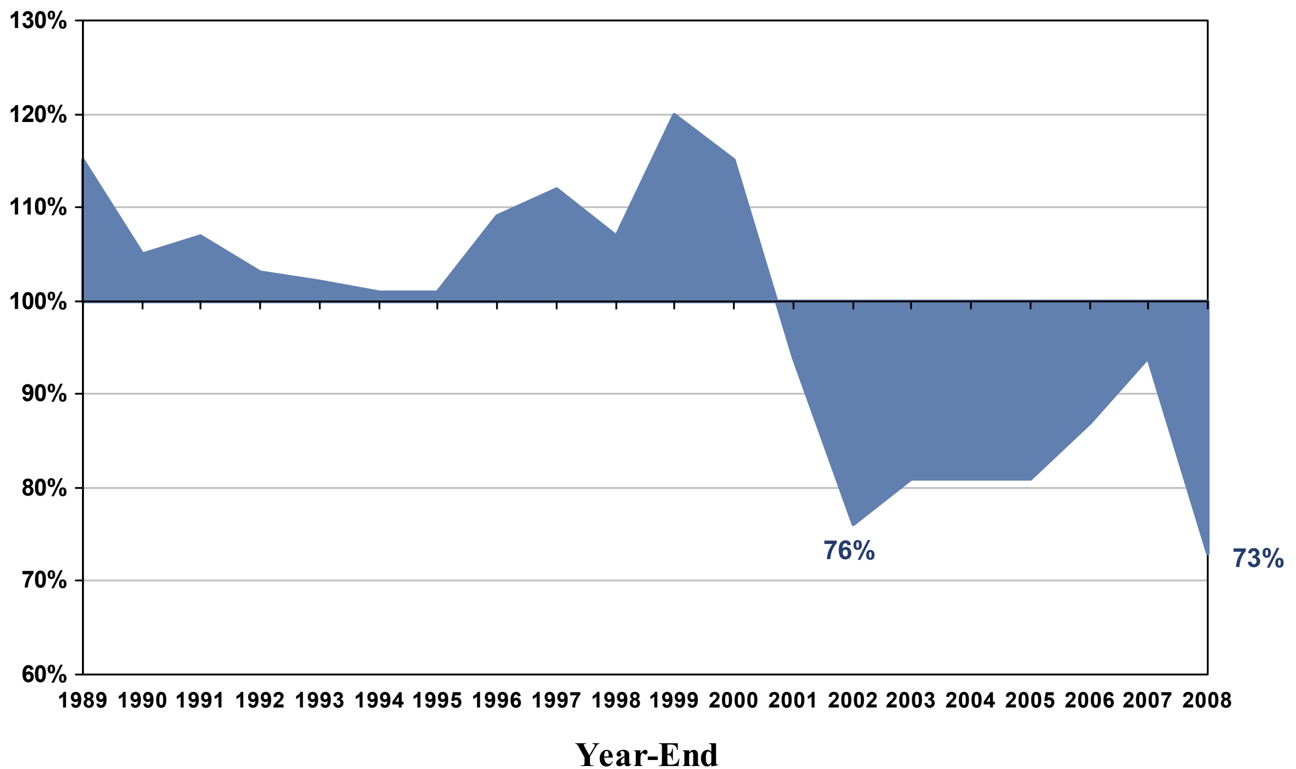
[2] Hewitt Associates, SpecSummary™ database (2009).

With more Americans now relying on defined contribution plans for all or part of their retirement income, these plans must now deliver more. Automatic enrollment and automatic escalation practices and policies in 401(k) plans are helping increase both participation and the rate of savings. Unfortunately, approximately 7 percent of *Fortune 500* organizations suspended their 401(k) matches for 2009 in response to the dire economic conditions. We believe around half of these organizations will reinstate the matching contributions in 2010, but this practice is troubling because it can reduce the cyclical benefits to employees of dollar cost averaging in investments.

Financial Requirements

The funded status of the nation's pension funds has varied dramatically over the past 20 years. Significant swings in interest rates, coupled with two challenging equity environments in the last decade, have created this volatility. Exhibit 2 illustrates the average pension accounting funded status among the S&P 500—as measured by the FAS 87 projected benefit obligation calculations used to drive income statement and balance sheet calculations.[3] This data documents the fact that defined benefit pension plans have historically been reasonably well funded. However, as shown below, the two equity market crises of this decade have battered pension plan funded status.

Exhibit 2: Volatility in Pension-Funded Status Over Last 20 Years



Congress, the IRS, and the Treasury Department have taken steps to lessen the near-term cash contribution requirements associated with the current recessionary environment, ranging from passage of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) to more recent guidance from the IRS and Treasury regarding flexibility when selecting discount rates and asset smoothing techniques. These steps have been widely embraced and have been beneficial to the funding by defined benefit plan sponsors, though additional funding relief is badly needed on a temporary basis.

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[3] Hewitt Associates, "Study Findings: Benefit Plan Disclosure Under FASB Statements No. 87 and 106," (2009).

Despite the significance of some of these measures, many companies need greater short-term relief in response to the recession. Meeting the current pension funding requirements is forcing many employers to curtail their investment in new jobs, cut back on capital expenditures (also typically tied to jobs), and implement further retirement plan cutbacks. In the most extreme cases, the near-term requirements are adding to financial distress and could contribute to potential bankruptcy.

Another financial option and strategy for pensions, partly enabled by methodology employed in the PPA, includes “liability-driven investing” (often referred to as “LDI”). Many pension plan sponsors were anticipating adoption of LDI investment techniques to preserve pension-funded status and protect funded status levels. However, the swift onset of the market downturns in 2008 and 2009 required many organizations to put those plans on “hold,” pending recovery in the financial markets. Full adoption of LDI techniques following the market downturns would be the equivalent of “selling low and buying high.” Many pension plan sponsors are planning to adopt dynamic investment approaches to help secure funded status gains as the market improves. A continued orderly transition back to financial health for America’s pension plans will enable this.

Regulatory Requirements

Many companies, though fully supportive of sound financing of defined benefit pension plans, are becoming increasingly concerned with the staggering number of requirements for defined benefit pension plan sponsors following the passage of the PPA. The original intent of the Act—to ensure funding for defined benefit plans—is sound. But when the legislation was enacted, no one foresaw the deep recession ahead. Unfortunately, significant flexibility in how plans are managed has been lost, and the stringent requirements are commanding the attention of chief financial officers, treasurers, and other business leaders. In particular, the loss of flexibility in funding/credit balances and associated funded status reporting requirements have become challenging.

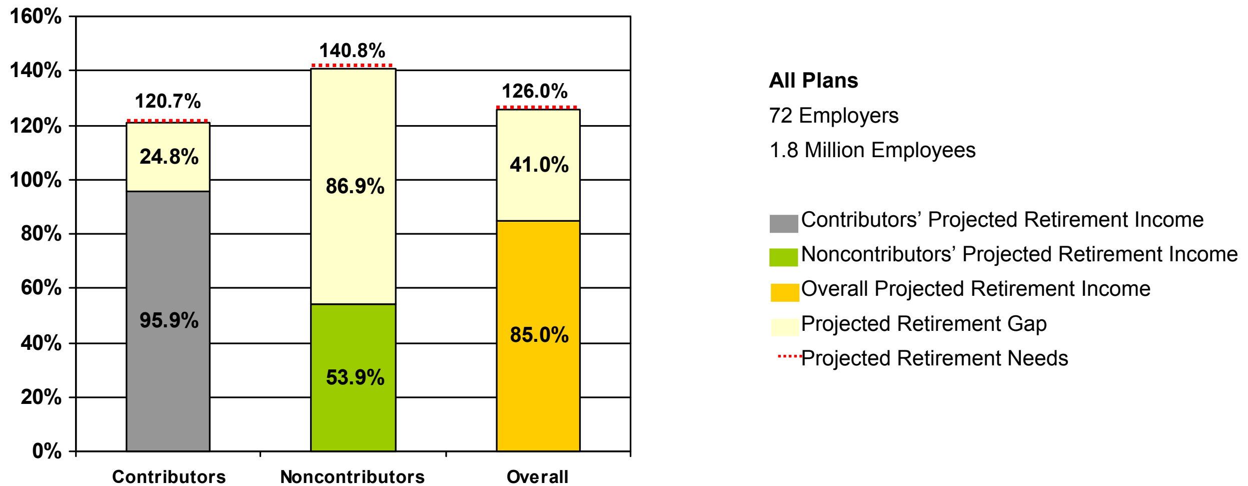
Although management oversight of pension issues is important and appropriate, understanding and complying with PPA requirements has become so onerous that it is taking the attention of business leaders when they need to place full focus on managing their core businesses during this critical economic period. Now is the time to create more flexibility within the system, without undermining the PPA and the long-term strength of defined benefit plan funding, to allow as many employers as possible to continue offering retirement plans through the recession and to create a bridge to next-generation retirement plans.

II. Impact of the Current Environment on Participants

The current retirement income plan environment as it translates to participant benefit levels is well documented in Hewitt’s 2008 study titled “Total Retirement Income at Large Companies: The Real Deal.” This study looks at anticipated retirement income needs and sources for nearly 2 million current employees at 72 large U.S. employers. The sources of income include projected defined benefit pension, defined contribution, and social security benefits. The results of our analysis suggest that many American workers—particularly those who are not contributing to an employer-sponsored plan—are not well positioned to reproduce pre-retirement living standards during their retirement years. And these conclusions were reached even before factoring in the effect of the economic crises of 2008 and 2009.

Exhibit 3 summarizes the high-level results of our analysis. The study found that employees contributing to 401(k) and other employer-sponsored plans are projected to produce, on average, a respectable 95.9 percent income replacement at retirement age 65, while those not currently contributing will produce only 53.9 percent.

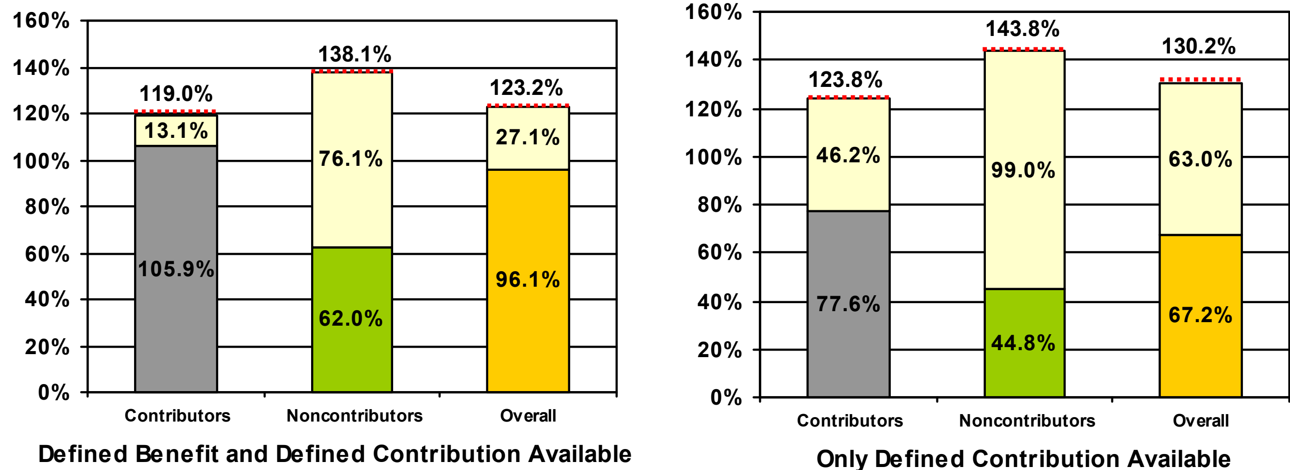
Exhibit 3: Projected Retirement Income Replacement Compared to Retirement Needs



Pension Plan Availability

Retirement income challenges are further exacerbated when defined benefit pension benefits are not available. The average projected age 65 income replacement for those employees eligible for defined benefit pension benefits is 105.9 percent (assuming they are contributing to 401(k) and other employer-sponsored programs). However, that figure drops by 28 percentage points, to 77.6 percent, for employees who are only eligible for defined contribution plan benefits. Exhibit 4 depicts this drop along with the associated retirement needs.

Exhibit 4: Projected Retirement Income Replacement by Plan Availability



2008 and 2009 Economic Crisis

The findings summarized above are calculated based on participants' account balances before the significant economic downturn experienced in 2008 and early 2009. A Hewitt study this year estimated the impact of recent market experience on anticipated retirement income replacement. Those calculations suggest that retirees will experience a further reduction in retirement income replacement expectations of approximately 4 percent. An economic recovery and better employee savings behaviors could reverse some of this downward pressure for properly invested participants. However, the potential reductions resulting from both movements away from defined benefit pensions and the current economic crisis are significant, and it is unlikely that, in the short term, most employees will be able to fully recover what they've lost.

III. Impact of Pensions on Financially Distressed and Bankrupt Organizations—and on Their Employees

When companies are in dire financial straits, the defined benefit plan is a common area to look to for cost cutting. Frequently, the defined benefit plan is frozen—never to return—and lower-valued benefits are typically provided in its place. In a company reorganization or Chapter 11 bankruptcy, benefits are protected by the PBGC, but only to a point.

While some workers and retirees see little or no cutback in benefits upon plan freeze and bankruptcy, others, depending on the plan, can see significant reductions. And, while benefits for many existing retirees may not decrease, retirees close to retirement age may suffer the greatest loss. These mid- to late-career workers need to adjust their retirement savings to make up for the lost retirement benefits in a very short period of time. This group of workers is vulnerable not only with respect to their diminished retirement benefits, but also in their ability to locate a higher-paying job which, of course, hurts their ability to save for retirement. In addition, these workers have less ability to take long-term risks with any savings or 401(k) plans, which limits their upside potential. A solution is needed to help maintain ongoing defined benefits to provide a level of protection needed for this group.

This section discusses how financial distress and bankruptcy can affect benefit value through plan design changes, organization change and restructurings, and distress termination and PBGC takeover of the plan.

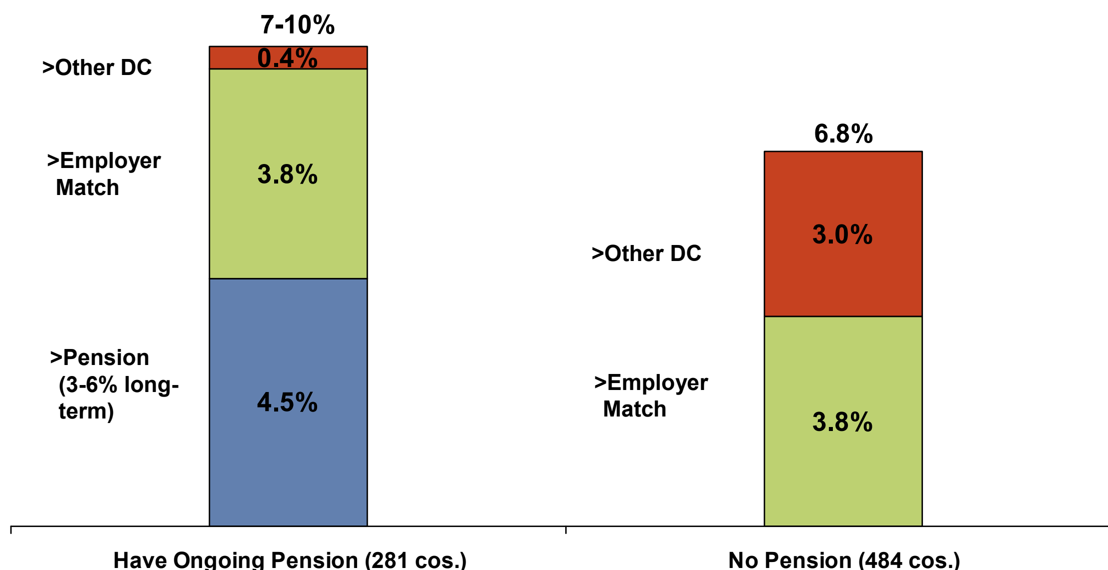
Plan Design Changes

Despite reports that the recession has "ended," we continue to meet with employers on a daily basis who understandably ask for additional ways to cut costs in these tough economic times. In many cases, those efforts are necessary to create resources to fund the current pension obligations. Assets have been reduced by the recent financial turmoil, and the PPA regulations mean that funding obligations are now due much sooner. In some cases, these discussions lead to planning for the eventual termination of the pension plan to avoid further volatility. And even plan sponsors who wish to maintain an ongoing defined benefit plan, despite financial challenges, are required by the PPA to freeze participant accruals when a plan's funding deteriorates.

Organizations continuing to sponsor defined benefit pension plans provide retirement income benefit value equal to 7 percent to 10 percent of pay per year, while those providing defined contribution benefits provide maximum benefit value equal to 6.8 percent of pay on average.[4] Exhibit 5 illustrates the various components of this benefit value.

[4] Hewitt Associates, SpecSummary™ database (2009).

Exhibit 5: Employer-Provided Retirement Benefits Value (as % of payroll)



This shift from higher benefit value, including defined benefit pension plans, to lower-value defined contribution plans, is accompanied by the shift in the relative safety of the programs to participants. Under defined contribution plans, participants are responsible for managing both investment and longevity risks, although employers recognize that most participants need increased education and advice to give them the knowledge and experience to do this effectively.

Organizational Change and Restructurings

We also see evidence of organizations moving away from defined benefit plan sponsorship in company reorganizations. In financially troubled situations where an asset sale occurs, the sale rarely includes the pension plan. This has been the case for dozens of pension plans in 2008 and 2009 and illustrates why it is vital that future defined benefit plans diversify risk. Risk sharing with third parties would have helped ensure corporate willingness to continue pension plan sponsorship.

"Distress" Pension Termination and Pension Benefit Guaranty Corporation (PBGC) Takeover

Participant losses are not limited to employer actions before bankruptcy. Upon bankruptcy and PBGC takeover, participants stand to lose benefit value. Any benefits an employee earned in excess of the PBGC maximum guarantee are generally lost. The current PBGC maximum guarantee is $4,500 per month in 2009—generally affecting longer-service and higher-paid workers. Also, in many cases, pension plans provide subsidies for employees retiring early. Upon a PBGC takeover, employees not already meeting the requirements for a subsidy can never grow into it in the future. Based on PBGC rules, this includes any participants who actually recently met the eligibility for a subsidy. These participants may have anticipated this subsidy when making other retirement plans and can suffer a significant reduction in expected retirement pay. They may have, in fact, already retired and begun to receive benefits, having just met the eligibility. And, while perhaps less significant, any employees who have not met minimum vesting standards, such as five years of service, will lose their entire benefit.

Hewitt's conceptual models for the future would address this shortfall. They include fully funded accounts, which leverage professional asset management as well as pooling for risks during retirement years—greatly mitigating the potential for loss.

IV. Reinventing Retirement Security in America

Providing adequate retirement income for working Americans presents major challenges for us as a nation. As the baby boomers age, our failures to prepare adequately for retirement will become increasingly apparent. Many Americans already find that their retirement savings are not sufficient to reproduce preretirement living standards. This situation has worsened with the current recession and resulting employer and employee actions regarding pensions and other retirement plans.

We don't believe that Congress should expect employers will return to defined benefit pension plans in their current form, although there may be continued interest in alternative plan designs if Congress can provide additional flexibility and supportive underlying policies. Otherwise, the risks and exposure to corporate balance sheets is just too large for many employers to begin "jumping back in the ring" in any meaningful way.

At the same time, ***defined contribution and 401(k) plans*** cannot be the sole long-term vehicle for individual and employer-provided retirement savings. In other testimony, Hewitt has suggested steps that might be taken to strengthen defined contribution plans in the future.[5]

We believe the future of retirement income should include both defined benefit and defined contribution plans. This necessitates the reinvention of defined benefit plans structured to better manage risks. Effective third-party and participant risk-sharing mechanisms need to be better developed. Employees and retirees need to understand their risks, and they also need to understand when it is appropriate to involve others in the management of those risks. Investment and longevity risks are too challenging for retirees with little or no marginal resources to manage. Said differently, retirees with only enough savings to "get by" shouldn't be taking on the full risks of managing their savings over their life expectancies or being overly cautious for fear of running out of assets.

Hewitt has compiled a number of potential models that incorporate increased flexibility and risk sharing in pension plans that could better serve employers and retirees in the future. These models will create increased security on the front end, which would better inoculate employees from the risks associated with bankruptcies and reorganizations.

Our conceptual models incorporate:

- Participant accounts managed on a plan-wide basis to ensure prudent investment approaches and professional asset management and techniques;

- "Life cycle"-based account earnings—so the appropriate risk/return characteristics are in place during all phases of employment and retirement;

- Flexibility in employer and employee funding—allowing different organizations and industries to participate at the appropriate level, fostering global competitiveness;

- Flexibility in plan sponsorship—allowing different levels of risk taking at the employer level, or alternatively shifting sponsorship to third-party organizations; and

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[5] Alison Borland. Hearing before the ERISA Advisory Council to the Department of Labor. "Approaches for Retirement Security in the U.S." (Date: September 17, 2009)

Alison Borland. U.S. Congress. Hearing of the House Subcommittee on Health, Employment, Labor and Pensions. "401(k) Fair Disclosure for Retirement Security Act of 2009." (Date: April 22, 2009)

- Annuity requirements and options—to ensure adequate long-term investment and longevity protection for workers, retirees, and their families.

V. How Congress Can Help

Throughout this testimony, we have noted situations where participants are in peril because of the loss of retirement income benefits due to both the recession and the changes in employer-sponsored retirement plans. In the short term, we encourage Congress to take actions that preserve, as much as possible, the funding and other flexibility necessary for employers to provide ongoing and meaningful pension benefits in the current environment. This will lead to continued and ongoing benefits for as many participants as possible, and will help ensure we exit the recession without digging an even deeper hole for the current and future generations' retirement income prospects.

Specifically, we recommend urgent action to provide temporary relief at least to ease the burden of the accelerated funding requirements of the PPA. In enacting the PPA, no one foresaw the occurrence of this recession, which has been described by many commentators as the worst since the Great Depression. For that reason, the following changes are needed with respect to defined benefit pension plan funding:

- Widening—either temporarily or permanently—the asset "smoothing" corridor for pension funding calculations from 90 percent to 110 percent of market value, to 80 percent to 120 percent of market value (80 percent to 120 percent was allowed under pre-PPA rules); and

- Allowing amortization of 2008 asset losses over a period of time significantly longer than seven years, recognizing the unique nature of those events in financial history.

These provisions have been recommended and proposed by Hewitt and other groups in the past 12 months and are necessary to create sufficient smoothing in pension funding requirements in light of current economic times.

We need to exit the current recession with a workforce prepared for retirement and the resources necessary to continue fueling the economy. As a nation, we cannot afford to plan for unlimited protections in bankruptcy. Structures must be put in place that will allow companies to thrive in the post-recession environment, rather than "hunkering down" to prevent losses in bankruptcy and other situations.

This plan sponsor flexibility is also necessary to bridge to the next generation of retirement plan design and management in the United States. Congress needs to work with all stakeholders to develop this next generation of tax-favored retirement income structures to support effective third-party and participant risk-sharing mechanisms.