CAPITOL ANALYSTS NETWORK, INC.

Stuart J. Sweet, President **November 3, 2005**

Washington Redefines Defined Benefit Obligations

Congress is unlikely to tackle Social Security's $10 trillion unfunded liability problem this session, but there is a better than fifty percent chance it will act on the $450 billion funding shortfall of private defined benefit plans. If a reform bill becomes law, the Pension Benefit Guaranty Corporation (PBGC) projects that asset managers of defined benefit plans should see their assets under management increase by up to twenty percent, compared to current law, over the next decade. Should legislation the Bush Administration supports pass, it will be welcome news to all companies that manage defined benefit plans and it could be especially good news for securities holders of Barclays, Capital Guardian, Alliance, State Street Global, JPMorgan Fleming, Wellington, Goldman Sachs, Morgan Stanley, PIMCO, and BlackRock. On January 24, 2005 *Pensions and Investments* reported that these are the ten firms the largest 200 pension funds use most often.

It is not difficult to understand why defined benefit plans are underfunded by $450 billion; current rules encourage it. Here is the explanation provided by Ann Combs, the Assistant Secretary of Labor, when she testified before the Senate Finance Committee, available in full at www.senate.gov/~finance/hearings/testimony/2005test/actest030105.pdf :

< "Weaknesses in the current rules include, for example, multiple and inaccurate asset and liability measures and discount rates, smoothing mechanisms, credit balances that allow funding holidays to continue even as funding levels deteriorate, excessive discretion over actuarial assumptions, and varying and excessively lengthy amortization periods. As a result, companies can say they are fully funded when in fact that are substantially underfunded."

< " ... These weaknesses contribute to the ability to manipulate funding targets which is of particular concern given the fact that they are set too low. There is no uniformity in liability measures under current law. In some cases, employers can stop making contributions when a plan is funded at 90 percent of 'current liability.' But current liability is not an accurate measure of pension funding requirements; even 100 percent of current liability is often far less than what will be owed if a plan is terminated."

< " ... As an example of how all of this can affect workers and retirees, the U.S. Airways pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $1.5 billion shortfall."

< "... Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion."

Congress and the Administration Agree: Scrap the Old Rules

Numerous details must be settled before Bush can hold a signing ceremony. However, the Administration and House and Senate leaders appear to agree on these four principles:

- Assets should be more accurately measured. No party recommends that mark-to-market be used as of a reporting date. However, they all recommend something that comes closer to this method. Currently, assets are "smoothed," with values determined using an average over the last five years.

- Liabilities should be more accurately measured. Actuaries for plan sponsors have discretion over how to calculate the present value of their liabilities. They also can be "smoothed" over four years. Perhaps the most significant variable is the interest rate used to discount the stream of future payments the sponsor expects over the next fifty years. Small changes can send total liabilities upward or downward by ten percent or more. Instead of using a single interest rate to discount, employees would be grouped by the time before retirement. Different interest rates would be used to discount each time-before-retirement cohort.

- Shortfalls will be more rigorously measured. A plan will be considered "fully funded" when assets and liabilities are at least equal. Currently, a plan is considered fully funded when assets equal only 90 percent or more of liabilities.

- Shortfalls will have to be made up much more quickly. Current law can give sponsors up to thirty years to pay up. Sponsors also get credit for making payments more than necessary in past years, and even get "interest" for such payments, although poor returns may have more than offset the "extra" payments. Sponsors will have only seven years to eliminate shortfalls.

Impact On Asset Managers

It has been said, "Making predictions is risky, especially when it involves the future." However, it does not appear risky to anticipate that money managers will see inflows when many plan sponsors, both financially weak and strong, will have to make rapid catch up payments to fully fund their plans.

The Policy, Research & Analysis Department of the Pension Benefit Guarantee Corporation (PBGC), the federal agency inside the Labor Department that insures defined benefit plans, analyzed the impact of the Administration's reform proposal. It found that the "funded ratio" of all plans would rise from its current 75 percent to 95 percent by 2015 if the Administration's reforms were adopted, compared to only 80 percent in 2015 if they are not. Translation: plan sponsors must send asset managers enough added resources, or in some cases send their workers notices they are freezing or terminating their defined benefit plans, to raise funding coverage by nineteen percent over the next ten years. See Chart 2 at

www.pbgc.gov/docs/wp_040605.pdf . Given economies of scale in asset management, it should become significantly more profitable to be in the defined benefit management business if the reforms pass. Asset managers would receive the added funds starting in early 2007.

Impact on the Markets: Bullish for Bonds

While the total amount of funds sent to defined benefit plan managers would grow, it is probable that the mixture of equities, fixed income securities, cash, and other assets chosen by plan sponsors would change. When there is less room to "smooth" assets and liabilities, market volatility translates in heightened volatility of reported earnings. Under some versions of reform, plan sponsors could see their reported annual earnings gyrate by 70 percent due to pension accounting changes. To reduce such volatility, corporate plan sponsors might ask managers to reduce the equity portion of their portfolios from a current average of 65 percent to 50 or 60 percent and to boost the fixed income portion by a like amount.

Impact on Specific Companies

Companies must state their pension obligations, as their actuaries define them anyway, in their SEC reports. The following table lists the largest funding shortfalls at the end of 2004:

Defined Benefit Plans With the Larger Dollar Shortfalls ($ in Millions)

Sponsor	2004 Funded Status	Fair Value of Plan Assets	Benefit Obligation	Assets as % of Benefit Obligation
Delta Air Lines	($5,298)	$6,842	$12,140	56%
Lockheed Martin	($4,876)	$22,139	$27,015	82%
Northwest Airlines	($3,820)	$5,425	$9,245	59%
Boeing	($3,804)	$38,977	$42,781	91%
Raytheon	($3,637)	$11,273	$14,910	76%
DuPont	($3,507)	$18,250	$21,757	84%
Exxon Mobil	($3,471)	$7,299	$10,770	68%
Ford Motor	($3,449)	$39,628	$43,077	92%
United Technologies	($3,139)	$15,672	$18,811	83%
Goodyear Tire & Rubber	($3,122)	$4,598	$7,720	60%
DaimlerChrysler	($3,035)	$18,785	$21,820	86%
Dow Chemical	($2,798)	$12,206	$15,004	81%
Exelon	($2,761)	$7,014	$9,775	72%
American Airlines	($2,687)	$7,335	$10,022	73%
Alcoa	($1,951)	$8,800	$10,751	82%
Electronic Data Systems	($1,942)	$5,895	$7,837	75%
Xerox	($1,918)	$8,110	$10,028	81%
Johnson & Johnson	($1,816)	$7,125	$8,941	80%
Hewlett-Packard	($1,726)	$3,244	$4,970	65%
Northrop Grumman	($1,618)	$17,720	$19,338	92%

Source: Pensions and Investments

This sheds some light on which companies may have to make catch up contributions if reform legislation passes, possibly hurting earnings for the next seven years.

Legislative Status

The Senate Finance Committee and the Senate Health, Education, Labor, and Pension Committee share jurisdiction over pension issues in the Senate. The two Republican Committee Chairmen, Chuck Grassley (R-IA) and Mike Enzi (R-WY), are united behind a single proposal. Importantly, the ranking Democrats on both Committees, Max Baucus (D-MT) and Edward Kennedy (D-MA), also support it.

Last month, Senate Majority Leader Frist tried to place S. 1783, the Pension Security and Transparency Act, before the full Senate, expecting rapid passage. When he did so, the bill's bi-partisan sponsors ran into a glitch. Senators DeWine (R-OH) and Mikulski (D-MD) objected to the bill's provisions that require companies with rating agency grades below investment grade to make faster catch-up pension payments than others. The duo argues that such payments will hurt struggling companies unnecessarily, and they want the accelerated payment requirement targeted only to firms that have ratings below investment grade and who also have significantly underfunded plans. S.1783 likely will once again be headed to the floor and for Senate passage as soon as the concerns raised by DeWine and Mikulski are addressed.

The House companion bill, H.R. 2830, the Pension Protection Act, cleared the House Committee on Education and the Workforce on June 30, 2005. The House Ways and Means Committee also has a say in pension matters, and it has yet to take up pension reform because it views legislation to cut spending and taxes as higher priorities. Once the Ways and Means Committee acts, the House leadership likely will schedule pension reform for floor passage soon thereafter.

Later, representatives of the House and Senate would meet to iron out the final bill under the watchful eye of the White House.

What Could Go Wrong

Some observers believe that the credit rating issue is so important to the bill's authors that it will prove impossible for a compromise to be found between them and DeWine and Mikulski. Without a compromise, these two Senators could threaten a filibuster, making final Senate passage a time consuming proceeding, with even passage in doubt.

There is a second contentious issue. The Senate has inserted in its bill a provision giving the airlines fourteen years to make their catch up payments, rather than seven years that all other companies must meet. The Chairman of the House Committee on Education and the Workforce, John Boehner (R-OH), is adamant that there be no special treatment, especially for companies most likely to default. One important reason to pass a reform bill is to prevent companies from

forcing the PBGC to take over their pension obligations. To Chairman Boehner, the lengthy delay given to the airlines is a recipe for an industry wide PBGC bailout. If a permanent impasse develops between the House and Senate over this issue, there will be no signing ceremony.

Finally, separate legislation may take some of the urgency out of passing a reform bill. Congress is expected to take up legislation before year end that will cut the deficit. Among the provisions expected to clear Congress is one that boosts pension insurance premiums from $19 per person per year to as much as $46.76 per person per year. This will go some way toward eliminating the PBGC's projected long run deficit which optimists place at $23 billion.

For further analysis or information, contact Capitol Analysts Network, Inc. at:

4405 Bradley Lane
Chevy Chase, Maryland 20815
website: www.capitolanalysts.com

Phone: 301-951-9161
Fax: 301-652-5831
Email: capnet@xecu.net

© 2005 Capitol Analysts Network, Inc. All rights reserved

Disclaimer: This report is based on material we believe to be accurate and reliable; however the accuracy and completeness of the material and conclusions derived from said material in this report are not guaranteed. Capitol Analysts Network, Inc. makes no recommendation as to the suitability of such investment for any person.

Capitol Analysts Network, Inc. employees or officers may have long or short positions or holdings in the securities or other related investments of companies mentioned herein.