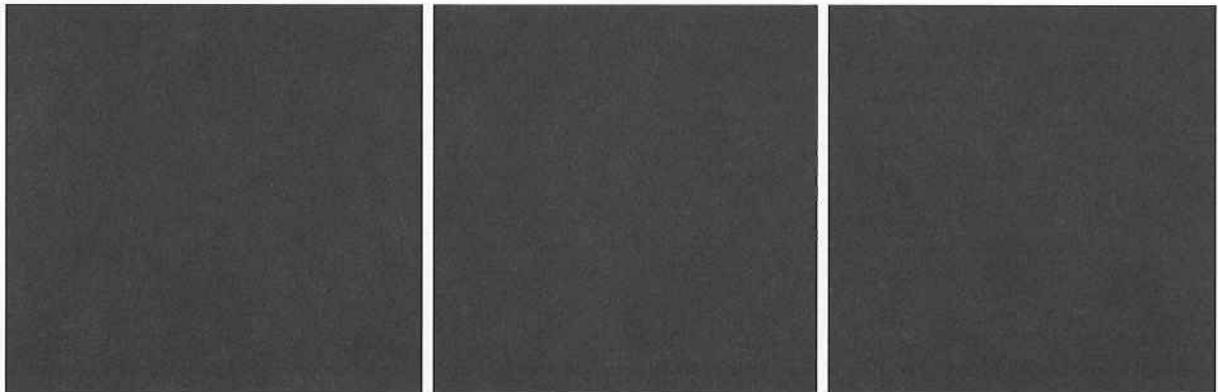


November 2008    Number 64

I N T E R N A T I O N A L  
PENSION LAWYER

Journal of the International Pension and  
Employee Benefits Lawyers Association



## The U.S. economic crisis and its impact on pensions



*Frances Phillips Taft  
Faegre & Benson, LLP  
United States of America*

*Phillips Taft, Frances  
The U.S. Economic Crisis and Its Impact on Pensions*

*6 p.*

*Faegre & Benson, LLP, 1900 Fifteen Street, Boulder, Colorado, 80302-5414*

*Ph: (303) 447-7891, Fax: (303) 447-7800*

*E-mail: [fphillipstaft@faegre.com](mailto:fphillipstaft@faegre.com)*

*The United States is currently in the midst of a severe economic crisis and could be facing its worst economic recession in decades. Over the past few months, the federal government and the American people have been focused on addressing problems with the financial markets and ascertaining the appropriate response to a weakening economy. The severity of the situation has resulted in an overall loss of investor confidence in the financial markets worldwide. With the recent election, President-Elect Barack Obama has made the economy one of the priorities of his new administration.*

*The most direct effect of the financial crisis on pensions in the United States has been the value collapse of financial assets such as corporate equities and bonds. On October 7, 2008, Peter R. Orszag, the Director of the U.S. Congressional Budget Office (CBO), testified before the U.S. House of Representatives Committee on Education and Labor on how the housing, credit and financial troubles battering the economy have affected retirement savings in the United States. Director Orszag stated in his testimony that as a result of the economic situation, the CBO estimates that pension plans in the United States have lost as much as \$2 trillion—roughly 20 percent of their value. The CBO director further stated that the value of the assets held by defined benefit plans has declined by approximately 15 percent over the past year. He also confirmed that public pension plans have been affected by market developments: Assets held by state and local governments' pension plans have declined by more than \$300 billion between the second quarter of 2007 and the second quarter of 2008.*

*The current economic climate in the United States has raised significant concerns not only for the employers and plan sponsors of defined benefit and defined contribution plans, but also for their participating employees. Workers in the United States have viable concerns about retirement security and a heightened sense of anxiety regarding their retirement planning. There is also concern among employers regarding the impact that the stock market will have on funding obligations of corporate-defined benefit plans in the United States, The American Benefits Council has advised members of Congress of the significant challenges involved in implementing the new funding requirements and the concern among some employer sponsors that defined benefit plans are simply*

*too unpredictable from a financial perspective. The American Benefits Council has lobbied Congress and sought changes to raise awareness of the core issues. It has recently prepared a 10-point plan incorporating proposals to provide immediate relief to plan sponsor members and plan participants.*

*There is no question that funding for the U.S. Social Security system needs immediate attention. U.S. Social Security revenues are currently greater than its outlays, but as the baby-boom generation retires and the growth in the number of Social Security beneficiaries increases, the outlays will grow faster than revenues. According to the 2008 Social Security trustees report, payouts from the Social Security system will begin exceeding incoming revenue in 2017, and the system is projected to be insolvent by 2041.*

*It is anticipated that President-Elect Barack Obama will pursue major policy changes to protect retirement security in the U.S.—changes which will be central to reforms that will also address the financial services market. It is likely that these changes will dramatically change the U.S. pension landscape and that the U.S. retirement plan system will come under a level of scrutiny we have not seen since the 1980s. All parameters of the system will be scrutinized, including qualified plan limits, discrimination rules, coverage rates, vesting and eligibility rules. It is also expected that derivatives are likely to be banned from pension funds investments as one of the first casualties of the credit crisis.*

*The trajectory of the current fiscal situation in the United States is unsustainable long term, particularly as it affects pensions and retirement security. No one knows for sure the real depth of the subprime/derivatives debacle, but one fact is crystal clear—significant change is needed and quickly. President-Elect Barack Obama, Congress and the American people are committed to dealing with these issues. However, any proposed solutions must address both the short-term issues facing the U.S. economy and the long-term issues such as funding for Medicare and Social Security as well as stabilizing the U.S. pensions and retirement markets.*

**Bibliography:** 1) Orszag, Peter R, *The Effects of Recent Turmoil in Financial Markets on Retirement Security, Testimony before the Committee on Education and Labor, U.S. House of Representatives* (Washington, DC: Congressional Budget Office, October 7, 2008). 2) Aon Consulting, *2008 Benefits and Talent Survey* (Chicago, IL: Aon Corporation, 2008). 3) American Benefits Council web site at <http://www.americanbenefitscouncil.org>. 4) Watson Wyatt, *U.S. Survey of Older Employees' Attitudes Toward Lump Sum and Annuity Distributions From Retirement Plans* (2007). 5) *The Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington, DC: GPO, March 2008).

The United States is currently in the midst of a severe economic crisis and could be facing its worst economic recession in decades. Over the past few months, the federal government and the American people have been focused on addressing problems with the financial markets and ascertaining the appropriate response to a weakening economy. The severity of the situation has resulted in an overall loss of investor confidence in the

financial markets worldwide. With the recent election, President-Elect Barack Obama has made the economy one of the priorities of his new administration.

The most direct effect of the financial crisis on pensions in the United States has been the value collapse of financial assets such as corporate equities and bonds. The U.S. stock market indexes (DJIA and NASDAQ) have both fallen

by more than 40 percent over the past year as the outlook for the economy deteriorated. Beyond the obvious impact on market performance, the corrosive effect of subprime mortgage losses and the unknown depth of the impact from unwinding derivatives are powering the resulting credit crisis. This has also significantly affected the pension fund industry and it will likely continue to do so for some time in the future.

### **CBO Reports Significant Losses**

On October 7, 2008, Peter R. Orszag, the Director of the U.S. Congressional Budget Office (CBO), testified before the U.S. House of Representatives Committee on Education and Labor on how the housing, credit and financial troubles battering the economy have affected retirement savings in the United States. Director Orszag stated in his testimony that as a result of the economic situation, the CBO estimates that pension plans in the United States have lost as much as \$2 trillion—roughly 20 percent of their value. The CBO director further stated that the value of the assets held by defined benefit plans has declined by approximately 15 percent over the past year. He also confirmed that public pension plans have been affected by market developments: Assets held by state and local governments' pension plans have declined by more than \$300

billion between the second quarter of 2007 and the second quarter of 2008.<sup>1</sup>

### **Retirement Security in the United States**

The current economic climate in the United States has raised significant concerns not only for the employers and plan sponsors of defined benefit and defined contribution plans, but also for their participating employees. Workers in the United States have viable concerns about retirement security and a heightened sense of anxiety regarding their retirement planning. Retirement savings are at a historic low and approximately 75 million Americans do not have access to an employer-based retirement program.

The current financial crisis in the United States has also reopened and highlighted the pros and cons of defined benefit pension arrangements and defined contribution plans, including 401(k) plans. The makeup of U.S. retirement assets has changed considerably over the last 10 years. According to Department of Labor (DOL) Form 5500 data, the number of active workers in private employer-defined contribution plans has been increasing while the number of workers in private employer-defined

---

<sup>1</sup> Orszag, Peter R, *The Effects of Recent Turmoil in Financial Markets on Retirement Security*, Testimony before the Committee on Education and Labor, U.S. House of Representatives (Washington, DC: Congressional Budget Office, October 7, 2008).

benefit plans has been decreasing, thus shifting the economic and market performance risk to employees. According to a 2008 survey conducted by Aon, "93% of employers offer some type of defined contribution (DC) plan, and only 30% offer a defined benefit (DB) plan. In response, almost 90% of employers have introduced tools to help employees understand how much they need to save for retirement...and 30% offer automatic enrollment."<sup>2</sup>

To date, the share of assets in defined contribution plans, such as 401(k) plans, and individual retirement accounts has increased, whereas the share of assets in defined benefit plans has diminished in reverse proportion. Because of the heavy emphasis on equities, the value of assets in defined contribution plans may have declined by slightly more than that of assets in defined benefit plans. Participants in defined contribution pension plans are more at risk since they absorb all of the losses incurred in an environment where employer-defined contribution programs have become the principal source of non-Social Security retirement benefits in the United States.

### Funding Requirements for Defined Benefit Plans

There is also concern among employers regarding the impact that the stock market will have on funding obligations of corporate-defined benefit plans in the United States. Employers that sponsor defined benefit plans are currently contending with new funding requirements imposed on defined benefit plans which became effective in 2008 via the Pension Protection Act of 2006 (PPA),

The PPA, signed into law on August 17, 2006, included provisions that strengthened defined contribution plans. It is the most sweeping pension legislation passed in more than 30 years and included a number of significant tax incentives to enhance and protect retirement savings for Americans. The PPA encouraged automatic enrollment so that more employees would participate in plans; facilitated default investments, which are a critical component of automatic enrollment arrangements; and provided new diversification rights to employees. It also included new funding requirements for defined benefit plans. These funding requirements are resulting in huge unexpected financial obligations for employers due to the fluctuations in the equity market. Companies now must fund their pensions based on the value of plan assets relative to liabilities (the present value of projected retirement payouts based on

---

<sup>2</sup> Aon Consulting, 2008 Benefits and Talent Survey (Chicago, IL: Aon Corporation, 2008).

accrued benefits). Under the old funding rules, pension sponsors could smooth their asset values based on market returns over a five-year period. Under the new rules, companies can only average returns over a two-year period, and the averaged assets cannot exceed current market value by more than 10 percent. The new rules are much closer to the so-called mark-to-market rules that have been implemented in corporate accounting, where assets are "marked" or valued at what the market will pay for them on a given day rather than smoothed over time. These new funding rules make pension funding obligations for defined benefit plans much more sensitive to even modest changes in interest rates and equity markets.

The American Benefits Council has advised members of Congress of the significant challenges involved in implementing the new funding requirements and the concern among some employer sponsors that defined benefit plans are simply too unpredictable from a financial perspective. The American Benefits Council has lobbied Congress and sought changes to raise awareness of the core issues. It has recently prepared a 10-point plan incorporating proposals to provide immediate relief to plan sponsor members and plan participants.<sup>3</sup> Efforts to delay implementation of the funding rules

effective to date have not been successful, but the Council has succeeded in achieving the inclusion of an asset smoothing provision in both the Senate and the House of Representatives versions of PPA "technical corrections,"

The 10-point plan is comprised of three parts. The first part of the plan concentrates on encouraging retirement savings as well as protecting retirement security, including protecting retirees from excessive untimely distributions by eliminating the age 70-1/2 (required minimum) distributions for either 2008 or 2009; and permitting one-time loans up to \$10,000 from plans or IRAs with repayments permitted up to five years (with or without interest at the election of the individual), without a penalty tax. The second part of the plan centers on the current pension funding requirements. Currently, the PPA only allows unexpected gains and losses to be smoothed so that the smoothed value stays within 10 percent of fair market value. Due to current market conditions, this is not sufficient relief—a solution with less volatility and a longer time frame is required. The third and final part of the council's plan focuses on the future; the proposals include enhancing financial education for participants and credits for small business retirement plans.

---

<sup>3</sup> See additional details on the 10-point plan on the American Benefits Council web site at <http://www.americanbenefitscouncil.org>.

## Social Security in the United States

Alarm bells have been ringing for years now about the impending depletion of funding available for Social Security and Medicare benefits and many Americans are cognizant of this risk. According to a survey conducted by Watson Wyatt, roughly 61 percent of older workers—those 50 to 64 years old—are not confident of receiving unreduced Medicare benefits, and 52 percent are not confident of receiving unreduced Social Security benefits.<sup>4</sup>

There is no question that funding for the U.S. Social Security system needs immediate attention. U.S. Social Security revenues are currently greater than its outlays, but as the baby-boom generation retires and the growth in the number of Social Security beneficiaries increases, the outlays will grow faster than revenues. According to the 2008 Social Security trustees report, payouts from the Social Security system will begin exceeding incoming revenue in 2017, and the system is projected to be insolvent by 2041.<sup>5</sup>

<sup>4</sup> Watson Wyatt, *U.S. Survey of Older Employees' Attitudes Toward Lump Sum and Annuity Distributions From Retirement Plans* (2007).

<sup>5</sup> The Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington, DC: GPO, March 2008).

## What is Next?

This year's presidential election may be one of the most important in recent memory, and its significance has been further heightened by the current financial crisis. The next president of the United States will have the opportunity to profoundly and dramatically affect the landscape of labor and employment law, and may well transform the American workplace for years to come.

It is anticipated that President-Elect Barack Obama will pursue major policy changes to protect retirement security in the U.S.—changes which will be central to reforms that will also address the financial services market. It is likely that these changes will dramatically change the U.S. pension landscape and that the U.S. retirement plan system will come under a level of scrutiny we have not seen since the 1980s. All parameters of the system will be scrutinized, including qualified plan limits, discrimination rules, coverage rates, vesting and eligibility rules. It is also expected that derivatives are likely to be banned from pension funds investments as one of the first casualties of the credit crisis.

President-Elect Barack Obama has not been silent on his views about the issues facing the retirement security of Americans—he is committed to ensuring that Social Security is solvent and viable for Americans. Given his previous statements, it is unlikely that

the new administration will raise the retirement age. Obama has also previously indicated that he is opposed to privatizing Social Security. It is possible that instead, as part of a bipartisan plan that would be phased in over many years, U.S. taxpayers making over \$250,000 annually will be contributing more to Social Security to keep it sound.

It is also likely that President-Elect Barack Obama will move forward to implement his automatic workplace Individual Retirement Account (IRA) proposal which is geared toward dramatically increasing both the number of Americans who save for retirement and the overall amount of personal savings for these individuals. The proposal requires employers without a qualified retirement plan to automatically enroll their employees in a direct-deposit IRA account. The aim is to dramatically increase savings by low- and middle-income workers that do not currently save for their retirement. After enrollment, employees retain the right to change their savings levels, reallocate investments or stop contributions to the account. In addition, temporary tax credits would be available to companies to defer the cost of establishing these arrangements.

### **Conclusion**

The trajectory of the current fiscal situation in the United States is unsustainable long term, particularly

as it affects pensions and retirement security. No one knows for sure the real depth of the subprime/derivatives debacle, but one fact is crystal clear—significant change is needed and quickly. President-Elect Barack Obama, Congress and the American people are committed to dealing with these issues. However, any proposed solutions must address both the short-term issues facing the U.S. economy and the long-term issues such as funding for Medicare and Social Security as well as stabilizing the U.S. pensions and retirement markets. ♦