

Human Capital IQ

Timely news and information on employee benefit and human resources issues

In this issue:

- **Just How Painful Are Pension Plan Deficits (And What Can Companies Do Now to Mitigate Their Risks in the Future)?** 1
- **Are You Ready for "Say-on-Pay"? Take the Test!** 4
- **Update on Comprehensive Health Reform: Employer Play-or-Pay and Taxing Employer Health Benefits** 5
- **Upcoming Dbriefs** 7

Just How Painful Are Pension Plan Deficits (And What Can Companies Do Now to Mitigate Their Risks in the Future)?

2008 was a terrible year for almost all investors, and defined benefit pension plans certainly were no exception. A glimmer of hope as equity values plummeted was a temporary spike in high-quality corporate bond yields, which are the benchmark for the discount rates used to value pension plans' liabilities. But yields plummeted during the last two weeks of December, leaving many plans well in the red as of key measurement dates used for financial reporting and funding purposes. Published estimates place the aggregate underfunding in all S&P 500 pension plans on December 31, 2008 at \$238 billion, compared to an aggregate surplus of \$95 billion as of December 31, 2007.¹ Some are calling it the second "perfect storm" in recent history, which is an apt analogy as plan sponsors work to assess the damage to their balance sheets and cash flows – and explore the options available to mitigate the potential harm if these "once-in-a-lifetime" events happen a third time.

What Steps can Pension Plan Sponsors Take to Mitigate Associated Financial Risks?

Even as plan sponsors work to deal with the fallout from the latest "perfect storm," many are looking ahead to the

next one – and trying to learn lessons from the past in time to avoid repeating the same mistakes. Typically, they are in a state of flux regarding plan investment policy, and are asking themselves the following questions:

- Where are additional pension savings?
- How can we manage the liability volatility more pro-actively?
- What actions/timing might we consider in the near term to achieve the most financial statement/cash requirement relief from our current sizable cash contribution?

The markets have again given us a rude lesson in uncorrelated risks. For years many may have believed that low interest rates were always good for the equity market and high rates were bad for it, allowing plan sponsors to justify substantial equity exposure against discounted-dollar liabilities. Unfortunately, interest rates are just one factor that affects equity prices, and can be swamped by massive and sudden adjustments to risk-pricing. Now, faced with pension deficits, plan sponsors may feel that it is exactly the wrong time to learn lessons and move to fixed-income. However, that should not condemn plan sponsors to always repeating the same mistake. Sponsors may wish to consider rethinking the correlation between final-salary-related liabilities and the performance of plan assets.



¹ "92% of S&P 500 Plans Underfunded – Wilshire," *Pensions and Investments* (April 16, 2009).

Obviously, fixed-income will continue to have a major, long-term role to ensure a strong element of technical correlation. Serious consideration is being given by many sponsors to purchasing a longer duration “umbrella” of fixed income securities with the current influx of new funding contributions. More risk adverse plan sponsors are considering the purchase of annuity contracts and remain under an insurance financial instrument umbrella. They feel they cannot afford to be burned again by the financial markets!

Perhaps, as markets recover, it will make good sense for the degree of correlation to be gradually strengthened. But what about now, and what about the rest of the portfolio?

Let’s revisit some basic principles about final-salary liabilities which have tended to lose their sharp edge since the 1980s. Over the long term, such liabilities are closely linked to inflation and economic growth. While equities are generally historically good at matching economic growth, they generally have in the past done a poor job responding well to inflation. Recall the 1970s, and again the market’s reaction to the first half of 2008 when oil and food prices took off. One plausible warning concerning the current steps to recovery is that we may be planting the seeds of severe future inflation – this time perhaps not through lack of financial discipline, but perhaps because it may be viewed by some as the lesser evil for our economy. Unfortunately, it could be the primary evil for final-salary pension plans.

So sponsors might take a different approach to equity-sector selection.

Instead of betting on the future top performers – something for which potential returns can be high but the science yet unproven – sponsors might instead consider choosing certain sectors for their inflation-fighting effectiveness. And a switch from other depreciated equities into these sectors might not be such a painful – or potentially regretful – exercise. A rebound in these types of equities may result whether or not our recovery is at the expense of higher consumer prices.

Do Workforce Reductions Improve Pension Funding?

Many employers have been forced to reduce their workforces during the past year as market conditions have deteriorated. The primary motivation for these reductions in force is to quickly cut the company’s costs, but can these actions also help ease pension deficits? The elimination of future accruals, loss of salary leverage for final pay plans, and savings from non-vested benefits certainly helps reduce plan liabilities. However, these factors typically have little positive impact on pension deficits in the near-term, and the reduction in active workforce in many cases has exacerbated the decline in funded status caused by investment losses.

There are several ways a workforce reduction can adversely affect a pension plan’s funded status. First, a number of employers have used early retirement windows and buyouts to help facilitate voluntary reductions. These can be very expensive programs that may serve to reduce the associated plans’ funded status. Even for companies that do not provide these supplemental pension benefits, heavy early retirement experience can be a further drain on the plan’s funded status by increasing plan liabilities and beginning the drawdown on plan assets.

Another potentially negative impact on plan funding comes from lump sum benefits. For employers who allow lump sum options for all exiting employees, this can be a drain on plan assets, particularly where the lump sum benefit is subsidized. Finally, if the workforce reduction is large enough, a partial plan termination can be triggered. If so, the unvested benefits of impacted employees may need to be vested, thus increasing the plan deficit.

So while the elimination of active employees will reduce the long term growth of pension liabilities, the near-term impact is often negative in terms of increasing pension deficits.

How Do Pension Plan Deficits Affect Corporate Balance Sheets?

For most U.S. corporations, the adoption of a new accounting standard (SFAS No. 158) put pension plan funded status directly on the balance sheet beginning with year-end 2006. The transition to the new accounting standard was not a significant event for many companies because their pension plans were generally well funded at the time. In fact, many reported sizeable balance sheet assets reflective of their plans' overfunded status.

The last two years have seen dramatic changes to pension plan funded status, as noted previously. Under SFAS No. 158, this meant ballooning balance sheet liabilities and large reductions in shareholder equity for many companies as of December 31, 2008. However, the impact of these pension deficits may not be quite as pronounced on sponsors' income statements. Even though pension funding rules now employ more of a "mark to market" philosophy with respect to plan asset values, accounting rules still allow significant "smoothing" of these fluctuations in determining accounting expense. So, for example, a plan sponsor might have seen a significant adjustment to shareholder equity at the end of 2008 based on the then-current funded status of the plan, but the pension expense for 2009 might not be dramatically higher than the prior year.

Unfortunately, weakened balance sheets resulting from pension deficits and other factors will translate into a number of near term problems for many U.S. corporations. First, the pension deficits may threaten debt covenants, forcing unwanted actions or debt restructuring. In addition, many companies will face lower credit ratings as a result of large projected pension contributions. This

will, in turn, increase borrowing costs at a time when such increased costs can least be afforded. Finally, the weakened balance sheets and associated increased pension contributions for some companies will likely place a further constraint on other critical corporate spending, such as research and development.

What About Funding Obligations?

Just before the storm hit, Congress enacted a dramatic overhaul to pension funding rules designed to keep plan assets at or near 100% of benefit promises accrued to date, and require plan sponsors to make up any shortfalls over a seven-year amortization period. One effect of the new funding rules is to make sponsors' annual funding obligations more sensitive to the types of fluctuations in equity values and interest rates that occurred in 2008, which coincidentally was the first year the new rules applied to most plans.

Concerned about the effect of dramatic increases in pension funding obligations for companies during a global recession, Congress stepped in to provide limited funding relief late in 2008. Unfortunately, key aspects of the relief are not available to sponsors of plans that had large funding shortfalls the year before the new rules took effect – the same plan sponsors who may be most in need of help. The IRS has since stepped in to provide additional relief for plan sponsors, but many believe that still more may be needed. Several new funding relief proposals have been introduced by key Members of Congress from both parties during the last couple of months, creating a sense of optimism that more help may be coming later this year. But unless and until that happens, many plan sponsors face significant pension funding obligations in the immediate future.

This article is based on written answers a group of Deloitte professionals provided in response to a series of questions posed by Financier Worldwide magazine. The article, "[Pension Plan Deficits – Impact on U.S. Corporations](#)," appeared in the June 2009 edition of Financier Worldwide. Please contact any of the following Deloitte professionals if you have questions or need additional information about the information presented in this article:

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Are You Ready for "Say-on-Pay"? Take the Test!

Perhaps fearing Congress would not have enough to do after debates over comprehensive health reform and climate change legislation have ended, the Obama Administration in July released two legislative proposals relating to companies' practices regarding compensation decisions for executives. The so-called "say-on-pay" proposal would, if enacted, require all publicly traded companies to give shareholders a non-binding vote on executive compensation packages; and a second proposal would establish new independence standards for the compensation committees responsible for negotiating executive pay packages. Even if these proposals are not enacted, the threat of new statutory mandates combined with increasing shareholder and media scrutiny is causing many companies to carefully review existing practices and take steps to prepare for and implement these types of changes. A new Deloitte-developed "Say-on-Pay Readiness" test is available to help companies with this process.

The American Recovery and Reinvestment Act (ARRA) of 2009 established a say-on-pay requirement on the approximately 400 companies receiving Troubled Asset Relief Program (TARP) funds. The Administration's proposal would impose similar requirements on all public companies, as follows:

- **Require a non-binding annual shareholder vote on compensation for all public companies.** All public companies would be required to include a non-binding shareholder vote on executive compensation as disclosed in the proxy for any annual meeting held after December 15, 2009.
- **Compensation subject to the vote includes pay packages for senior executive officers.** The disclosures that would be subject to the say-on-pay vote include tables summarizing salary, bonuses, stock and option awards and total compensation for senior executive officers, as well as summaries of golden parachute and pension compensation and a narrative explanation of the board's compensation decisions.

- **Mandate a separate vote on golden parachutes in the case of a merger or acquisition, including disclosure of the amounts executives will receive.**

The proposed legislation would allow shareholders to vote on any payments to executives, while requiring companies to disclose, in a clear and simple format, the exact amounts senior executive officers will receive if a merger occurs.

The Administration cited the U.K.'s experience with similar say-on-pay requirements in support of its proposals. The U.K. adopted rules requiring an annual non-binding vote on pay in 2002. Additionally the Administration noted growing support for say-on-pay among U.S. shareholders. According to the Administration, shareholder propositions for say-on-pay votes have doubled during the last 3 years, from over 50 in 2007 to over 100 so far this year. These proposals have won majority support from shareholders of 19 companies in 2009, up from approximately 14 in 2008 and 8 in 2007.²

As a further check on executive compensation the Administration has also proposed legislation that would enhance independence requirements for compensation committees. The focus would be not just on preventing conflicts of interest between compensation committee members and management, but also on ensuring compensation committees have the authority and funding to choose their own consultants and legal counsel.

Take the Say-on-Pay Readiness Test

Even with favorable majorities in both the House and Senate, there is no guarantee the Administration's proposals – or any other say-on-pay proposals – will be enacted. But with pressure coming from policymakers and shareholders, it might be time for companies that haven't done so already to begin assessing their readiness for say-on-pay. A Say-on-Pay Readiness Test has been developed by Deloitte to assist companies with that process. The test is a series of "Yes" or "No" questions designed to identify issues that might be scrutinized by

² This information is taken from a Fact Sheet (TG-219) published by the Administration on July 16, 2009. The Fact Sheet is available on the Treasury Department's Web site, at <http://www.treas.gov/press/releases/tg219.htm>.

shareholders with say-on-pay rights. The questions relate to what information is disclosed in the Compensation Discussion & Analysis (CD&A), the proportion of compensation tied to risk and long-term results, short- and long-term incentives, how executive pay is linked to performance, the extent of disparity between the CEO's total compensation and that of other top executives, the availability of special perquisites for executives (such as personal use of corporate aircraft), retirement benefits, and severance agreements with executives, among other things.

If you have questions about say-on-pay or would like to take the readiness test, please contact Michael Kesner (mkesner@deloitte.com) or your Deloitte advisor.

Update on Comprehensive Health Reform: Employer Play-or-Pay and Taxing Employer Health Benefits

As the contours of the comprehensive health reform debate begin taking shape it appears increasingly likely that an employer "play-or-pay" mandate will be included in whatever bill might come out of the Congress this year. Although there are significant differences among the key bills under consideration, employer "play-or-pay" has become a common theme. But proposals to tax some or all of the value of employer-provided health benefits appear to be losing momentum, at least for now.

Details change regularly, but the following chart summarizes the "play-or-pay" mandates under consideration according to information available in mid-July.

	America's Affordable Health Choices Act (H.R. 3200)	Affordable Health Choices Act (Senate HELP Committee)	Senate Finance Committee ³
Employer Mandate ("Play")	Offer coverage to employees and contribute at least 72.5% of premium cost for single coverage and 65% for family coverage.	Offer coverage to employees and pay at least 60% of the premium cost.	Offer coverage to employees and pay at least 50% of the premium cost.
Fee Amount ("Pay") [applies only if the "Play" mandate is not satisfied]	8% of payroll, to the Health Insurance Exchange Trust Fund.	\$750 per full-time employee not offered coverage.	Options under consideration include a set per employee fee based on total annual payroll, or a tiered penalty based on a percentage of annual payroll.
Small Employer Exemption	Employers with annual payroll less than \$250,000 would be exempt from play-or-pay mandate. Employers with annual payroll of \$400,000 or less would be subject to a reduced fee for not meeting the minimum coverage requirements, as follows: <ul style="list-style-type: none"> • 6% for companies with annual payroll between \$350,000 and \$400,000 • 4% for companies with annual payroll between \$300,000 and \$350,000 • 2% for companies with annual payroll between \$250,000 and \$300,000 	Employers with 25 or fewer employees would be exempt from the play-or-pay mandate.	None specified.

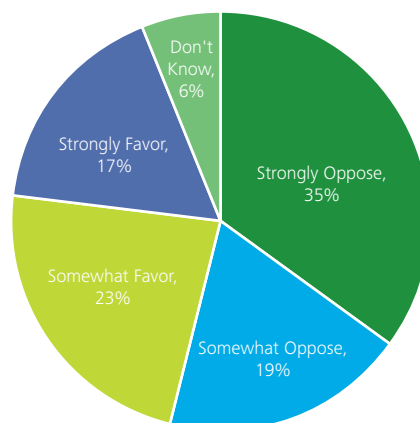
³ The Senate Finance Committee has not released an official bill as Human Capital IQ goes to press. This chart reflects options the Senate Finance Committee reportedly is considering.

	America's Affordable Health Choices Act (H.R. 3200)	Affordable Health Choices Act (Senate HELP Committee)	Senate Finance Committee ³
Other	<ul style="list-style-type: none"> Employers offering coverage would be required to enroll employees in the lowest cost premium plan unless they affirmatively elect other coverage or otherwise opt out of coverage. Employers with less than 25 employees and average wages of less than \$40,000 would be eligible for a health coverage tax credit. The maximum credit would be 50% of employer-paid premium costs, and would be available only to employers with 10 or fewer employees and average wages of no more than \$20,000. Employers providing retiree health benefits to pre-Medicare eligible retirees at least 55 years old would be eligible for a temporary reinsurance program. The program would reimburse the employer for 80% of these retirees' claims between \$15,000 and \$90,000, but the reimbursements would have to be used to lower costs for enrollees in the employer's plan. 	<ul style="list-style-type: none"> Employers with less than 50 full-time employees and average wages of less than \$50,000 would be eligible for a special tax credit if they offer health coverage to employees and pay at least 60% of employee health expenses. The maximum credit would be \$1,000 per employee with single coverage and \$2,000 per employee with family coverage. A bonus payment would be available for each 10% of employee health expenses above 60% that employer pays. Similar reinsurance program to the one included in H.R. 3200. 	<ul style="list-style-type: none"> Employers with 10 or fewer employees and average wages of less than \$20,000 would be eligible for a special tax credit if they offer health coverage to employees and pay part of the premium cost. The maximum credit would be 50% of the average total premium cost paid by the employer. Employers with more than 10 employees would be eligible for a reduced credit, which would gradually be phased out as firm size increases.

Taxing Employer-Provided Health Benefits

Treating some or all of the value of employer-provided health benefits as taxable income to the employee is an option that some policymakers have considered turning to in order to help defray the cost of comprehensive health reform, which is being estimated at more than \$1 trillion. The idea is appealing because of the potentially significant amounts of revenue that could be raised, but has not proven particularly popular from a political perspective. It's still on the table, but the latest edition of the Kaiser Family Foundation Health Tracking Poll suggests it won't be an easy sell to the American public.

Do you favor or oppose changing the law so that workers with the most generous health benefits would pay taxes on the money their employer puts toward their coverage?



Source: Chartpack: Kaiser Health Tracking Poll – June 2009", (#7924) The Henry J. Kaiser Family Foundation, June 2009

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Equity Award Programs: The Latest Cost-Cutting Innovations

Wednesday, September 02, 2009, 3:00 PM ET

In the current economy, companies are looking for ways to make equity plans more cost effective while still attracting and motivating employees. What is working? We'll discuss:

- Achieving an effective equity award mix and using award size guidelines to reduce dilution.
- Share plan charge-backs – pushing costs out to subsidiaries internationally to secure foreign tax deductions and increase cash repatriation.
- Capturing tax benefits from your plan in selected countries, including the UK and France.

Hear the results of a recent survey from Deloitte and the National Association of Stock Plan Professionals and learn about planning opportunities to reduce equity award program costs.

The People Challenges of IFRS Conversion

Thursday, September 10, 2009, 2:00 PM ET

Conversion to International Financial Reporting Standards is a multi-year process that impacts accounting, financial reporting, systems, and processes. What HR and organizational design issues should you consider for effective IFRS adoption? We'll discuss:

- The roles of finance, accounting, and corporate officers in IFRS analysis and assessment, conversion roadmap, and overall IFRS strategy.
- Design of HR and rewards structures to support IFRS conversion, including key employees' roles and responsibilities.
- Important questions to ask about the capabilities and resources of your IFRS team or conversion advisor.

Learn ways to position your organization for IFRS assessment and conversion through effective program management and governance.

About This Publication

Human Capital I.Q. is published by the Human Capital practice of Deloitte Consulting LLP. Questions on any of the subjects in this newsletter and request for address changes should be addressed to a Human Capital professional in the Deloitte Consulting LLP office nearest you. Comments and suggestions regarding the newsletter are encouraged and should be directed to:

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