Why Are Companies Freezing Their Pensions?

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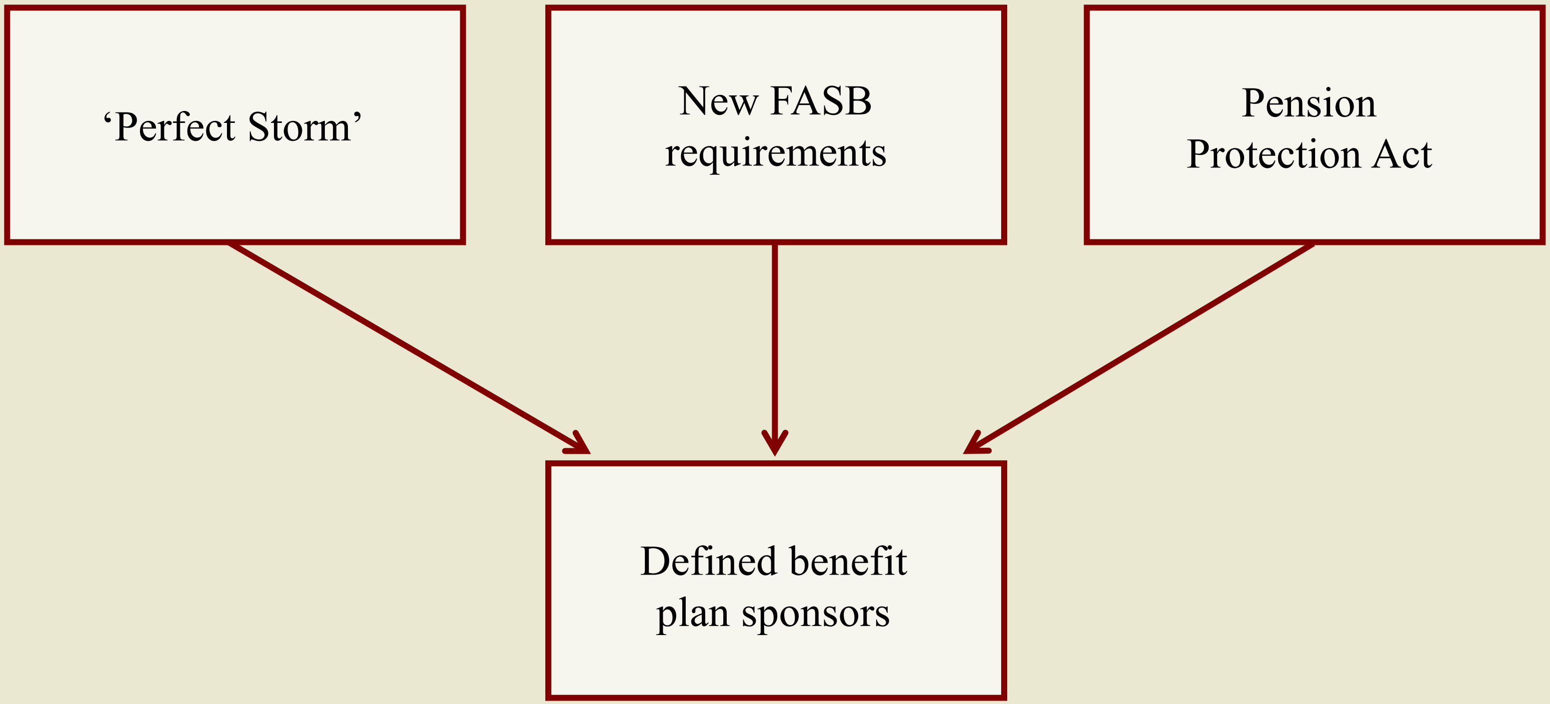
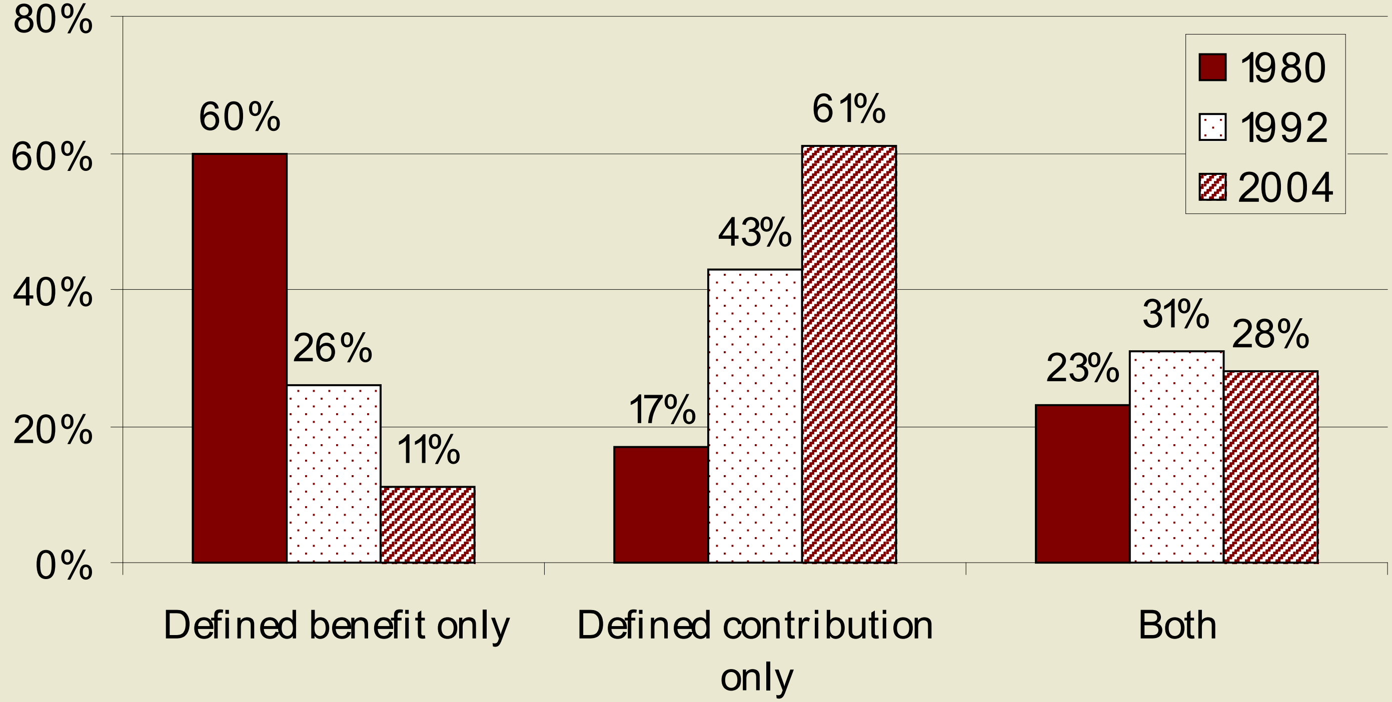
The early 21st century has been a difficult period for defined benefit plan sponsors.



Source: Authors' illustration.

And these difficulties came on top of prior economic shifts and cost pressures.

Private Sector Workers with Pension Coverage, by Pension Type, 1980, 1992, and 2004



Note: Although these calculations adjust for double-counting, some overestimation of coverage may still remain.
Sources: U.S. Department of Labor (2004) and authors' calculations from U.S. Department of Labor (2006).

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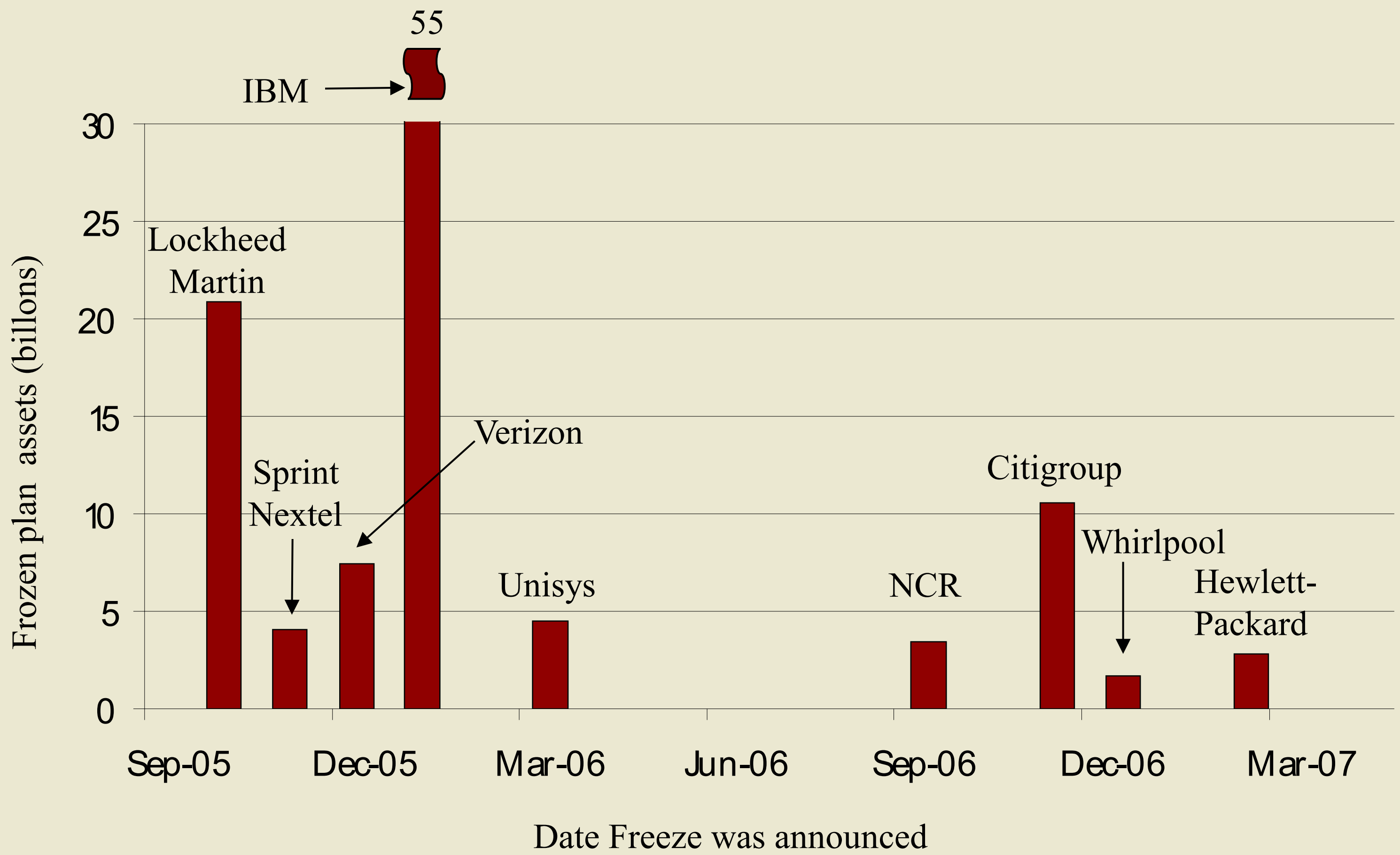
And the 21st century was always going to be hard, as plan sponsors were constrained from funding their full liabilities.

- Reduction in Full Funding Limits
- Impact of Reporting Requirements – FAS 87
- “Reversion Tax”
- Cap on Compensation for Funding Purposes

So, big healthy companies wanted out.



Source: Authors' calculations.

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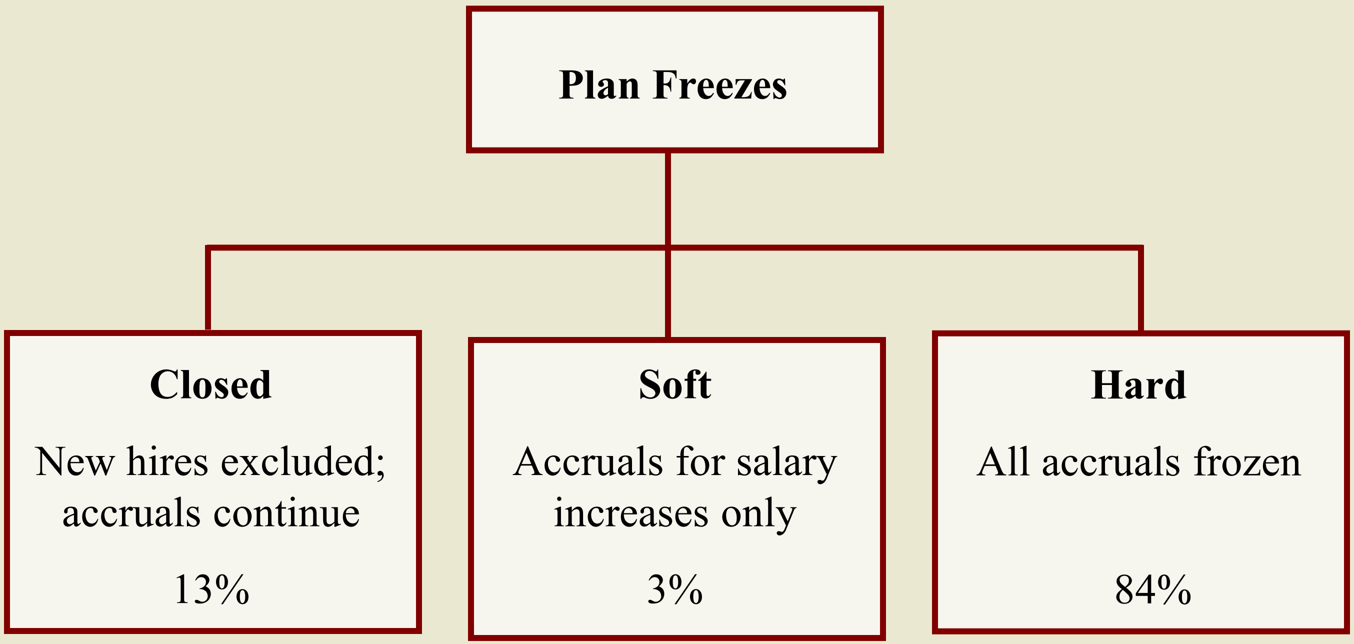
But terminations by healthy plans dried up.

Year	Adequately funded plans		Underfunded plans	
	Number	Liabilities (billions)	Number	Liabilities (billions)
1985-1989	48,519	$44	537	$2
1990-1994	36,340	28	692	5
1995-1999	15,620	21	438	2
2000-2004	6,969	13	595	32

Sources: Pension Benefit Guaranty Corporation. 2007. "Personal Communication with the Office of General Counsel, Disclosure Division." Washington, DC and Pension Benefit Guaranty Corporation. 1999 and 2005. *Pension Insurance Data Book*. Washington, DC.

Instead, the freeze became the weapon of choice.



Source: Authors' calculations.

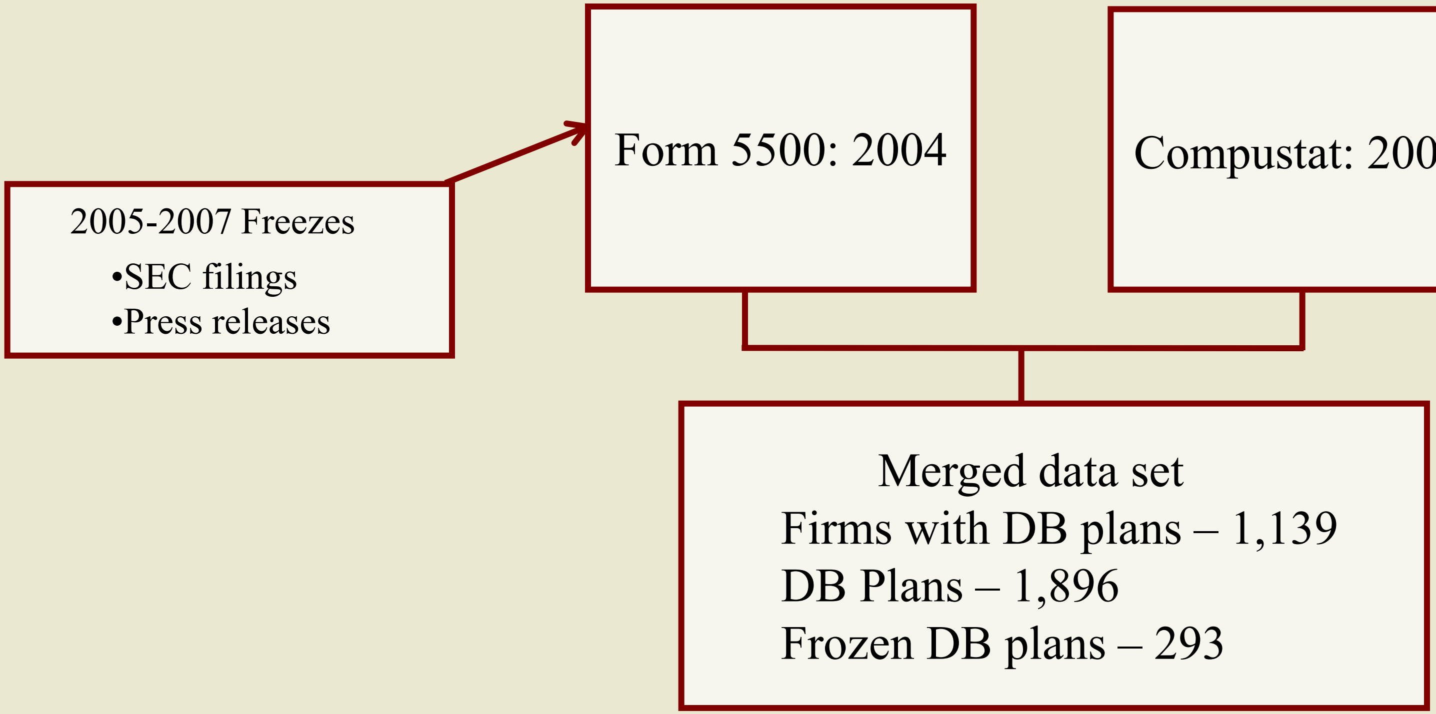
Why freeze a plan?

1) Volatility hurts financial statements.

2) The plan is easy to close.

3) Improves competitive position of firm.

To test these hypotheses, we constructed a unique dataset.



Source: Authors' illustration.

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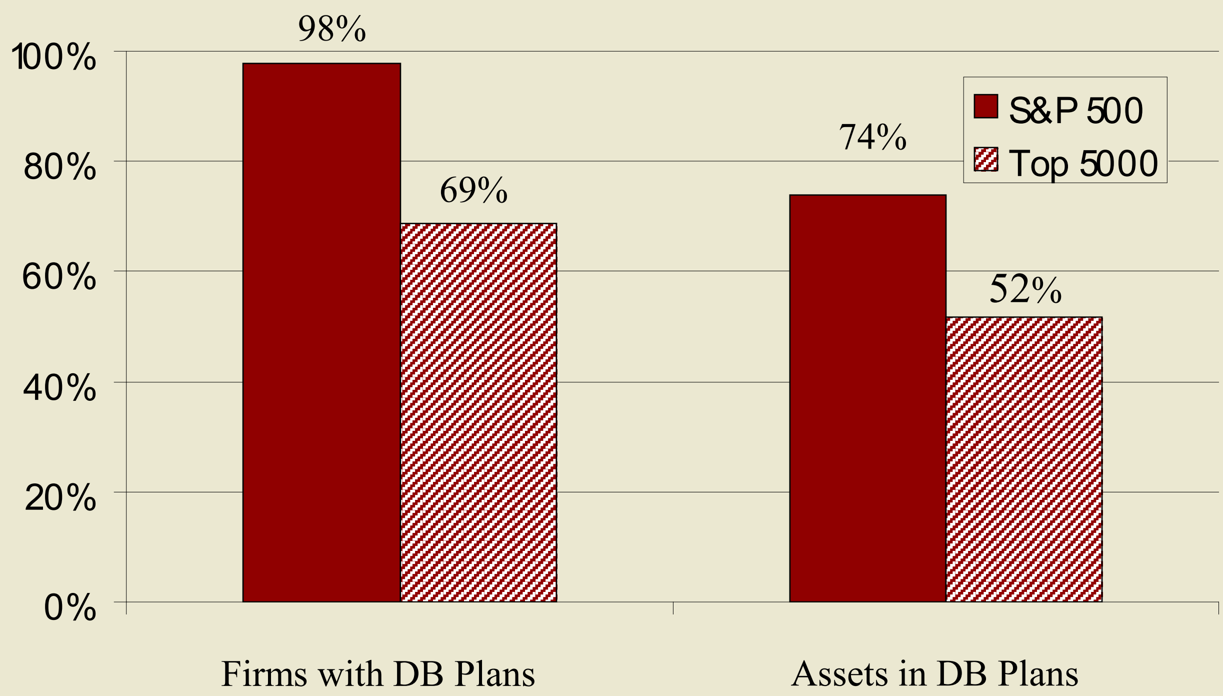
Our dataset covers the majority of both firms with DB plans and DB plan assets.

Ratio of Our Sample to Compustat Data for Firms With DB Plans and Assets in DB Plans



Source: Authors' calculations.

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Frozen plans have different characteristics than plans that are not frozen.

Medians of Sample Variables

		Not Frozen	Frozen (Hard)
1) **Financial considerations:**	Credit balance / net income	3.4	1.5
	Percent of plans underfunded ***	50.2	68.9
	AL – CL / market cap	0.2	0.0
	Credit risk***	BBB-	BB
2) **Easy to freeze:**	Active participants / employees***	16.9	4.8
	Percent of plans collectively bargained ***	40.9	29.4
	Percent of plans hybrid***	16.0	10.6
3) **Competitive position:**	Retired participants / total participants***	50.6	64.1
	Market capitalization	3.0	1.3
	Percent in industry with DC plans only***	69.4	44.6
	Industry R&D intensity	1.9	1.9

Significance: ***99 percent, **95 percent, *90 percent, +85 percent.

Source: Authors' calculations.

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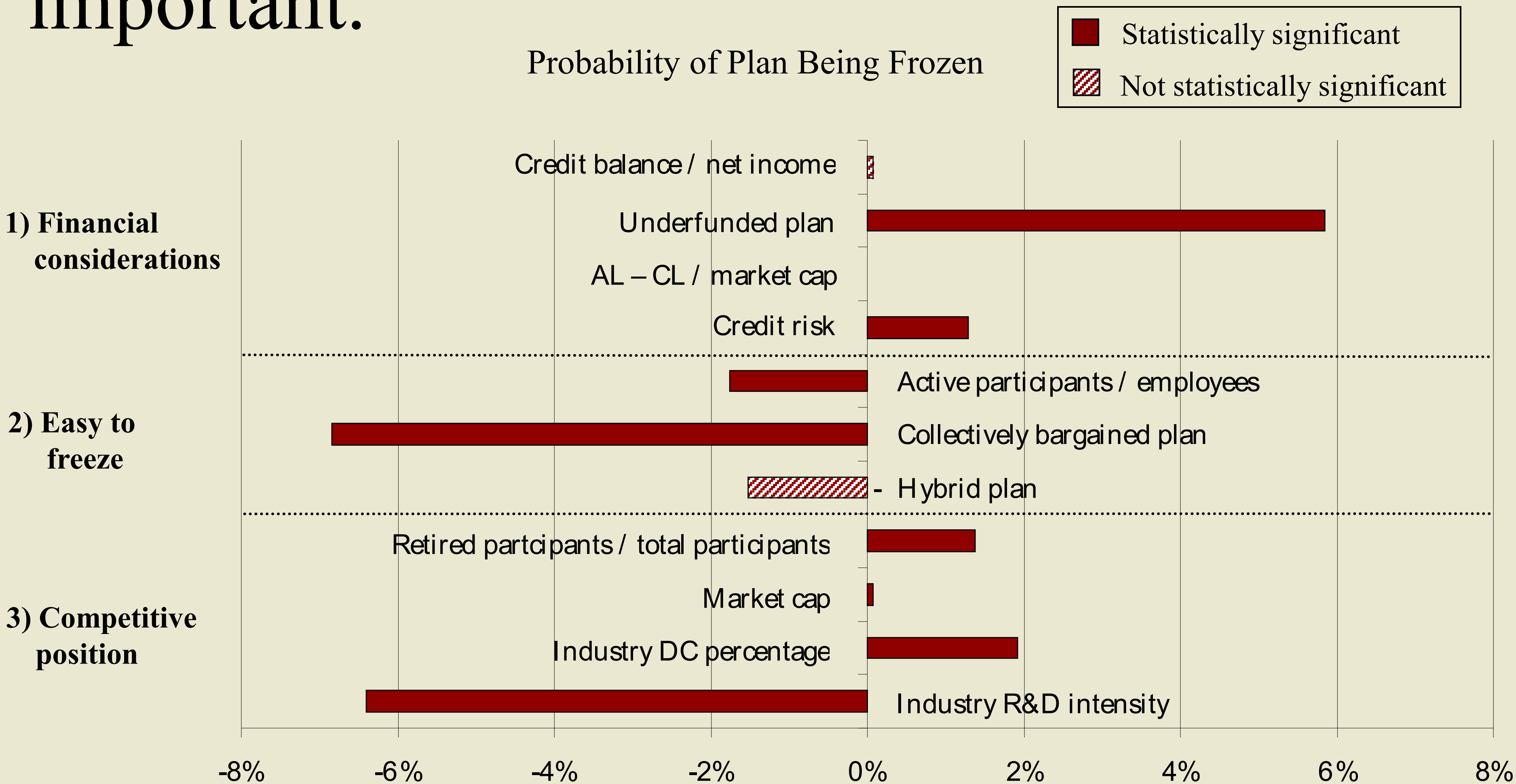
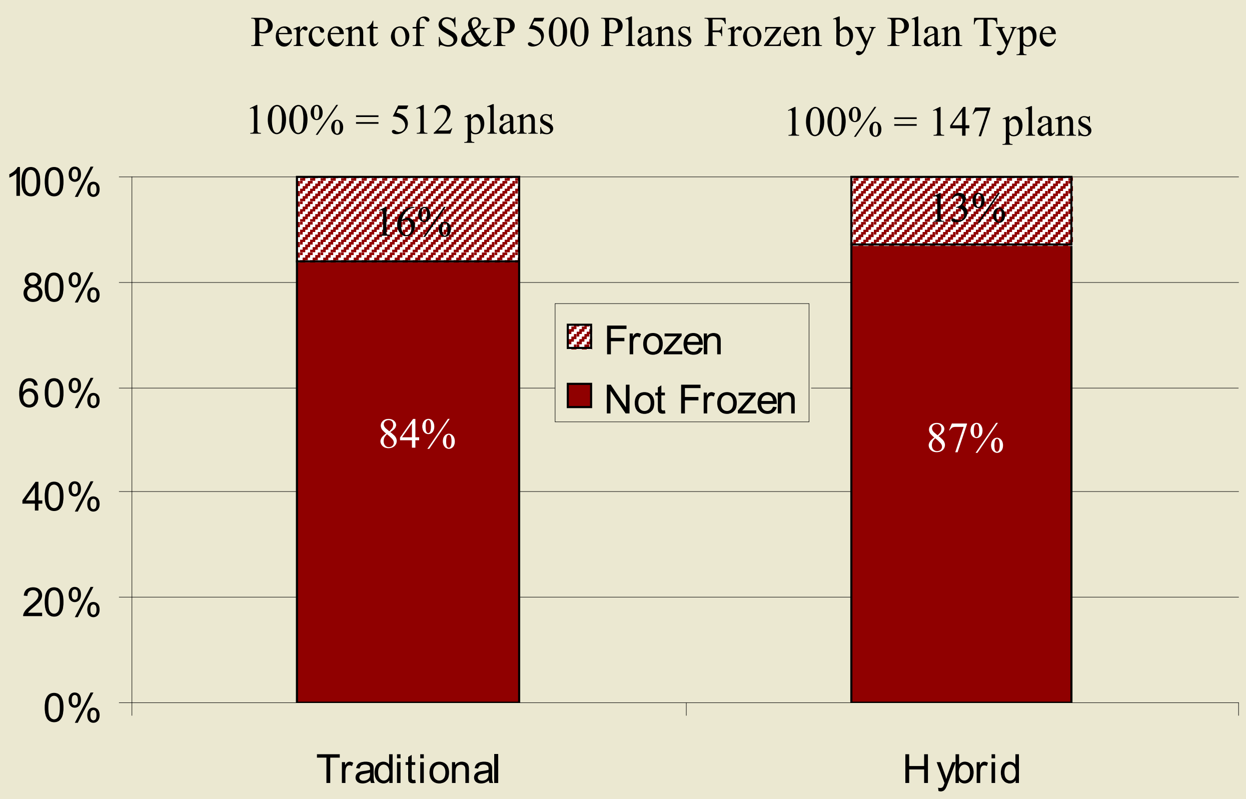
The results show that all three factors are important.



Source: Authors' calculations.

And hybrids do not appear to be the solution.



Source: Authors' calculations.

And financial factors do not appear to be driving freezes.

Savings	Expense
IBM	IBM
Projected liability	401(k) enhancements:
	Automatic 4%
	Match to 6%
− Accrued liability	+ Special award 5%
$3 billion by 2010	Company funded = 15%

Source: IBM. 2006. "IBM Changes U.S. Pension Plans, Effective in 2008, as Part of Ongoing Global Retirement Plan Strategy Shift." *Press release* (January 5).

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Firms cite volatility as key reason for freezing their plans.

Mercer	Aon	Towers Perrin
1. Reduce cost volatility	1. Reduce amount of contributions	1. Reduce cash flow drain
2. Save money	2. Reduce volatility of contributions	2. Reduce volatility in earnings
3. Offer competitive benefits	3. Lower administrative costs	3. Improve credit rating

Source: Mercer Human Resource Consulting. 2006. *A Closer Look at Recent High Profile Pension Plan Freezes*. New York: NY; Aon. 2003. "Aon Study: Pension Plan Freezes Moving to Forefront; More Possible Without Changes to Funding Rules." Press release (October 29); and Towers Perrin. 2006. *A Problem in Search of Solutions: A Study of Defined Benefit Pensions*. New York: NY.

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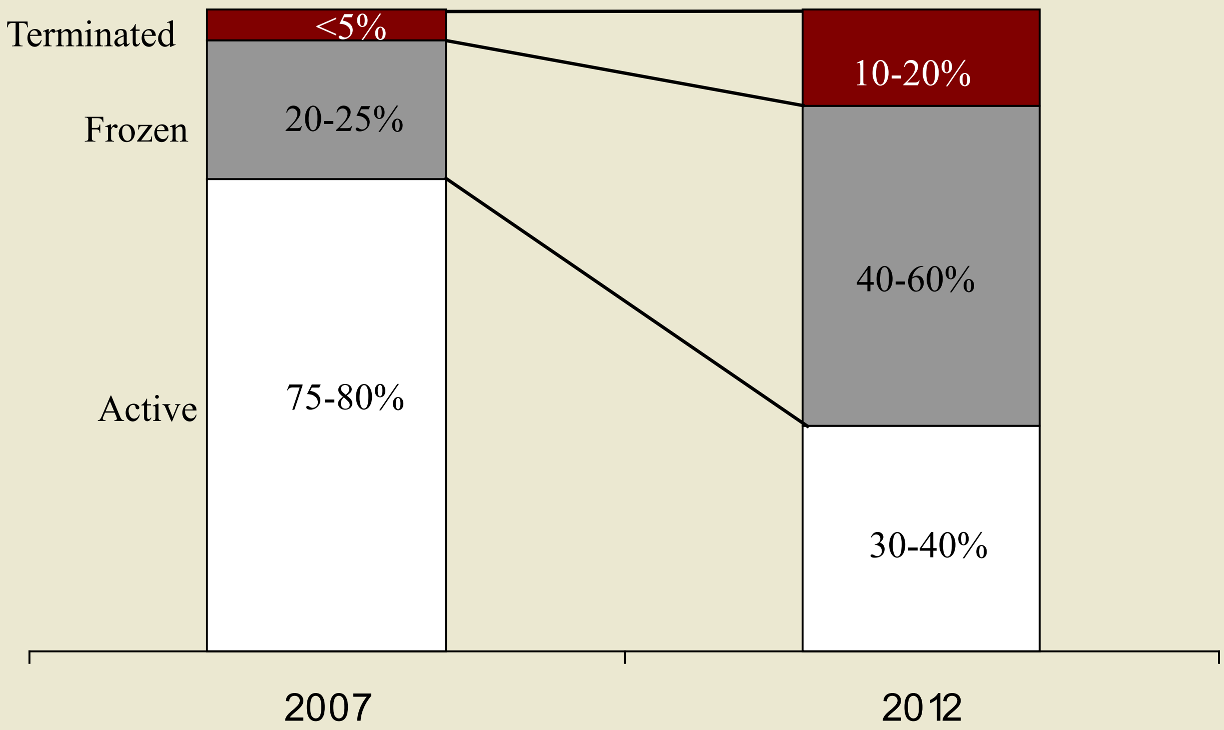
The bottom line: traditional defined benefit plans are going away.

Projected Total Private Sector Defined Benefit Assets by Plan Status, 2007 and 2012



Source: McKinsey & Company. 2007. *The Coming Shakeout in the Defined Benefit Market*. New York, NY.

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Conclusion

- Economics, regulatory factors, and a perfect storm have made defined benefit plans less attractive.
- Large healthy companies want out.
- Pension freezes have become the weapon of choice.
- Companies freezing their plans are responding to: 1) volatility; 2) ease of closure; and 3) competitive pressures.
- Traditional defined benefit plans are unlikely to survive.