

S&P 500 PENSION AND OPEB UPDATE

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The FASB today released its final requirement for the posting of net pension and OPEB obligation to the balance sheet. The regulation is effective with post December 15, 2006, filings. The final requirements follow the general exposure draft with three points of interest. First, projected obligations remain the standard (the lower accumulated value was lobbied for); second, private companies will get an additional six months to comply with the posting; and third, the use of the same evaluation date for the balance sheet and pension/OPEBs was delayed for two years (which brings it up to 2008, when the 2006 pension bill takes effect). We expect the pension/OPEB situation to change significantly over the next few years, as more people are affected by the continued retrenchment in benefits, and the issue gains in public awareness and eventually enters the political arena (see commentary at the end of the brief).

FASB - PHASE 1

The Financial Accounting Standard Board (FASB) today approved and released its new Pension and OPEB reporting requirements. The new regulations require companies to post on their balance sheets the net balance (assets less obligations) of both Pensions and Other Post Employee Obligations (OPEB). Previously the balances were reported in the financial notes. The reporting is required for post December 15, 2006 statements, and will impact the 2006 Annual Reports. **This FASB action is the first wake-up call for investors, retirees, workers and politicians.**

Based on current values, most companies will record increases in their posted obligations and direct or indirect reductions in their equity accounts. S&P estimates that the current reduction in tangible common shareholders equity will be in the 6 1/2% to 7% range. However, S&P notes that with interest rates slightly up, and expected to continue rising at a moderate pace, discounted obligations could shrink in size, as well as their posted value. Additionally, many companies have moved to eliminate or cap benefits that could reduce their current discounted costs. S&P expects a continuation of these reductions, with a greater emphasis on OPEB, which has fewer legal requirements. S&P also anticipates an increase in the trend to close and or limit defined pension plans, while enhancing 401(k) type savings accounts. Investors can expect to open up a very different annual report next February and even a more drastic change in February 2008. Basically, most companies will owe more via pensions and OPEBs, have less in their equity accounts, and report a greater impact on their operations than previously reported.

PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 was signed into law on August 17, 2006, and was the first significant legislation for pensions since the Employee Retirement Income Security Act (ERISA) of 1974. The majority of the provision takes effect in 2008. The legislation is designed to shore up under funded defined pensions, increase individual savings via automatic 401(k) type enrollments, and reduce defaults that result in pensions being taken over by the Pension Benefit Guarantee Corp (PBGC). Under the legislation, most companies are required to fully fund their pensions within seven years (by 2015), with new

rules spelled out as to how the measurement of assets and liabilities are to be performed. Chief among the changes are a reduction of the smoothing technique that permitted companies to report pension gains even in year in which they lost money and changes to the interest rates used to determine liabilities. Stress tests will be used to determine if severely under funded funds need to accelerate contributions. If they are, they will be restricted as to new benefits that could be issued and accumulated by workers and executives (even if the plans are separate). The legislation also gives troubled airline pension funds a greater time period to make-up their short falls, but limits their ability to increase benefits during the make-up period. Airlines, both in operation and operating under court supervision, are given additional time of between three and ten years to fully fund their pensions (up to 2025). Other significant features include the ability of companies to legally convert defined pensions into cash-balance plans, give fund sponsors the ability to provide investment advice (with safeguards against conflict of interests), make permanent the higher individual and catch-up 401(k) type contributions implemented in 2001 (that were set to expire in 2010), and give matching grants for low-income contributors. Also significant in the legislation is the ability of non-spousal beneficiaries to inherit tax-free IRAs or pensions (although tax will still be due when withdrawn), which was previously only tax-free if a spouse inherited it.

FASB - PHASE 2

The new requirement is the first phase of a two-step operation whose initial goal was a wider and simpler dissemination of the pension and OPEB situation, as well as to spur discussions about phase-two. The second phase will address the actual assumptions, methodology and presentation of pensions and OPEB. It is expected to span several years and will have a major impact on both balance sheets and income statements. **Given the current and expected continued reductions and eliminations in both pensions and medical plans and their importance to the general public at large, we believe the issues will intensify into a national debate. Core to this debate will be the responsibility and obligations of corporations, government and individuals.** We further believe that the decisions and course of actions will therefore be determined not just by the FASB, but also by the U.S. Congress and the President.

MOVING FORWARD

For 2006, absent a fourth quarter rally, portfolio income should be less than anticipated. Interest rates have moved up only modestly and are expected to continue at a slow pace. Most fixed income portfolios held short-term maturities, based on the anticipation of higher rates, so gains should be limited. The equity markets are expected to return 7.3% (5.4% capital appreciation and dividend of 2%), well below the 10.4% historical average. The result is that companies will again have to make additional contributions, most of which will be a cash-flow component. The market results should have minimal impact on net OPEB costs or balances due to their small funding (22%) portfolio size. More important to OPEB is the actual and expected change in medical costs, which could go up even more as rates rise or if inflation picks up. **If 2007 and 2008 produces historical market returns and rates continue to increase, S&P 500 pensions could post a 2008 surplus of funds; OPEBs, however, will remain severely under funded.** This does not change the actual value of the portfolio or the actual cash flow of benefits, but it does alleviate the situation on paper. We expect acceleration in the number of defined pension plan closings and further limitations in both pensions in general and OPEBs. Some companies may choose to terminate or limit plans prior to the implementation of the new legislation or the FASB

change. An open item for non-contractual retiree medical coverage is the new Medicare Part D. Last year some companies stated their intention to eliminate medical benefits and have their retirees move over to it. Now that the plan is out, more are expected. Little guidance is expected from the September 10Qs, but as fourth quarter earnings guidance emerges, additional commentary may be available. This years' 10Ks should provide significant information on the plans and the potential impact of the pension bill. S&P will monitor and release data and information as they become relevant.

COMMENTARY

Global pressures are now forcing U.S. concerns to scale back their retirement benefits to remain competitive. While the argument that they should have been addressed years ago is valid, the reality of the situation is that they are here now and companies are being forced to address them because they can no longer absorb or pass along the costs. The result has been a significant retrenchment of benefits by not just those companies facing difficult costs, but also their peers, who must now cut their costs (benefits) to remain competitive. Reductions have become not just common, but expected, with the only question now being of how much more of a reduction in benefits and or an increase in cost will be directly placed on to individuals. **As Americans live longer, the gap between existing benefits and personal wealth, and that of the escalating cost of staying healthy over that longevity, will grow.** Directly or indirectly, the U.S. government is the insurer of last resort. Whether it is via the PBGC, or as the medical provider via social or entitlement programs, the issue has become a government concern, with wide discussions as to its responsibility and obligation to alleviate. In the current climate of cost neutrality, Congress is attempting to pass along as much as it can onto companies, as well as strengthen current funding requirements (to reduce PBGC under funding). Eventually, government, in conjunction with the private sector, will need to address the situation and take painful steps. **The concern is that neither the public nor the private sector has shown a tolerance for the pain associated with the type of forward action needed to address the problem.** The longer the situation goes unaddressed, the stronger the measures will have to be to solve the situation. **In the end, however, individuals, either as taxpayers or consumers, will need to pay the bill, as well as live with the reduction in benefits and lifestyle.**

Additional information is available in the June 6, 2006 S&P research paper [S&P 500: Pensions and Other Post Employment Benefits](http://www.marketattributes.standardandpoors.com) at <http://www.marketattributes.standardandpoors.com>

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