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How Some Firms Boost the Boss's Pension

By MARK MAREMONT

Some major companies are boosting the value of retirement plans for top executives by using a generous formula when converting a pension into a single lump-sum payment.

The practice, which remained largely unknown until a recent change in federal disclosure requirements, can increase the value of a CEO's pension by 10% to 40%, sometimes amounting to millions of extra dollars. The additional sums aren't always fully reflected in annual pension-benefit tables included in proxy statements, or in company financial statements, due to the complexities of accounting and disclosure rules.

The list of companies turbocharging their executives' pensions includes Dun & Bradstreet, Hartford Financial, McKesson, PPG Industries, United Technologies, Texas Instruments and U.S. Steel, according to a Wall Street Journal examination of financial filings.

Pensions normally are paid out in installments over a retired employee's lifetime. But many executives prefer getting their pensions all at once, in part to avoid the risk of losing the benefit if the company later goes bankrupt.

There's no standard way to figure a lump-sum amount, and practices vary widely. The differences partly reflect the age-old tension between executives and companies over pay packages.

Some companies have been basing their calculations on an obsolete federal interest-rate formula that many experts say tends to produce an inflated payout. "It's a sneaky way to give executives larger pay," says Ron Gebhardtsbauer, a former U.S. Senate pension expert, now head of the actuarial-science program at Pennsylvania State University's Smeal College of Business.

One potential beneficiary is Ramani Ayer, the 61-year-old chairman and CEO of insurance giant Hartford Financial Services Group Inc. He hasn't yet retired, and company filings show his accumulated pension was valued at about $27 million as of the end of 2007, if paid out on an annual basis after he leaves.

However, according to Hartford's regulatory filings, Mr. Ayer plans to take the bulk of his pension in a lump sum when he eventually retires. Because of the way Hartford calculates lump sums, that boosted the value of his pension by more than a third, to $37 million, according to the filings.

John Hammergren, chief executive of drug wholesaler McKesson Corp., is another potential beneficiary. McKesson's formula increased the value of his lump-sum pension as of last March by at least $11 million, to almost $85 million, compared with a more conservative calculation, company filings show.

In a statement, a Hartford spokeswoman, Shannon Lapierre, said that the provisions of the pension plan covering Mr. Ayer were set when the company was part of ITT Corp., and were carried over after the 1995 spinoff. The actual pension payout to Mr. Ayer, she noted, could ultimately be larger or smaller than the $37 million because factors that go into the calculation can vary over time.

Hartford is among the major insurers that have applied for federal bailout funds. Congress requires some limits on executive pay for firms that tap into the bailout program, but that likely would only affect Mr. Ayer's lump-sum pension if he's fired. "If we receive the funds, we'd be following the guidelines on executive compensation and corporate governance," says Hartford's Ms. Lapierre.

A McKesson spokesman confirmed figures associated with Mr. Hammergren's pension, but otherwise declined to comment.

While some executives' benefits are being enhanced, millions of Americans are worried about the security of their own retirement funds. The stock-market plunge has caused a decline in the value of many 401(k)-style accounts, which are primary savings vehicles for about 50 million U.S. workers. Benefit levels in many regular pension plans have been frozen.

Less-Generous Formula

Business groups have successfully lobbied Congress to be able to use a less-generous formula when it comes to paying out pensions for regular workers. Pensions for most workers are federally regulated, and corporations argued that their coffers were being depleted by large lump-sum distributions.

In defending the way they calculate pension enhancements for executives, some of the companies, including United Technologies Corp. and Dun & Bradstreet Corp., say it's partly aimed at compensating executives for higher taxes they owe when they take their retirement benefits in a single payment, instead of spread out over their remaining lives. Just-retired executives often owe taxes at a higher average rate than they would years later when their income is down, according to this argument.

It's difficult to determine how many companies offer the beneficial payouts to senior executives, but pension experts believe it's a minority.

Texas Instruments Inc. and U.S. Steel Corp. say their lump-sum payout formulas for executives date back many years, and are offered to rank-and-file employees as well as executives. Texas Instruments says it calculates the lump sums two ways, and offers staffers whichever produces the bigger payout.

A spokesman for PPG Industries Inc. said its payout formula uses volatile factors that produce larger or smaller lump sums depending on the actual date an executive retires.

Generous payout calculations for executives' pensions have been around for many years. But they were almost impossible for the public to discern until 2007, when new Securities and Exchange Commission disclosure rules took effect. The rules required companies to place an overall value on their executives' pension benefits, and to reveal key assumptions underlying the calculations, among other things.

Details of how companies calculate lump-sum payments typically are buried in footnotes in proxy statements, often written in technical language.

Under

Taking Their Lumps

Pensions of four executives as calculated by their companies, vs. an alternative calculation that uses a less-generous IRS formula to value lump sums. Figures in millions of dollars

	John Hammergren McKesson Age 49	Ramani Ayer Hartford Financial Age 61	George David United Technologies Age 66	Charles E. Bunch PPG Industries Age 59
Pension calculated by company	$84.6	$37.0	$33.4	$10.5
Pension using IRS-set interest rate	$66.4	$31.9	$31.1	$9.1

Note: Calculations as of Dec. 31, 2007, for all except McKesson, which was as of March 31, 2008. IRS interest rates used are 417(e) rates in effect on the same dates. Totals include other pension benefits not payble in lump sums.
Source: Bolton Partners Inc., company filings, WSJ research

the special executive pensions most companies offer, high-ranking retirees are entitled to be paid a fixed sum every year until they (or their surviving spouses) die. Typically, companies calculate an average of the last few years of an executive's pay, then multiply that by a percentage factor based on years of employment.

For example, a 30-year veteran might be entitled to a pension equal to 45% of average final pay. If average final pay worked out to $4.4 million a year, the pension would be $2 million a year for life.

Over the years, companies and executives have found creative ways to increase that benefit -- for example, by adding extra years of service that the managers haven't worked. CEOs often negotiate such enhanced pensions when they are hired.

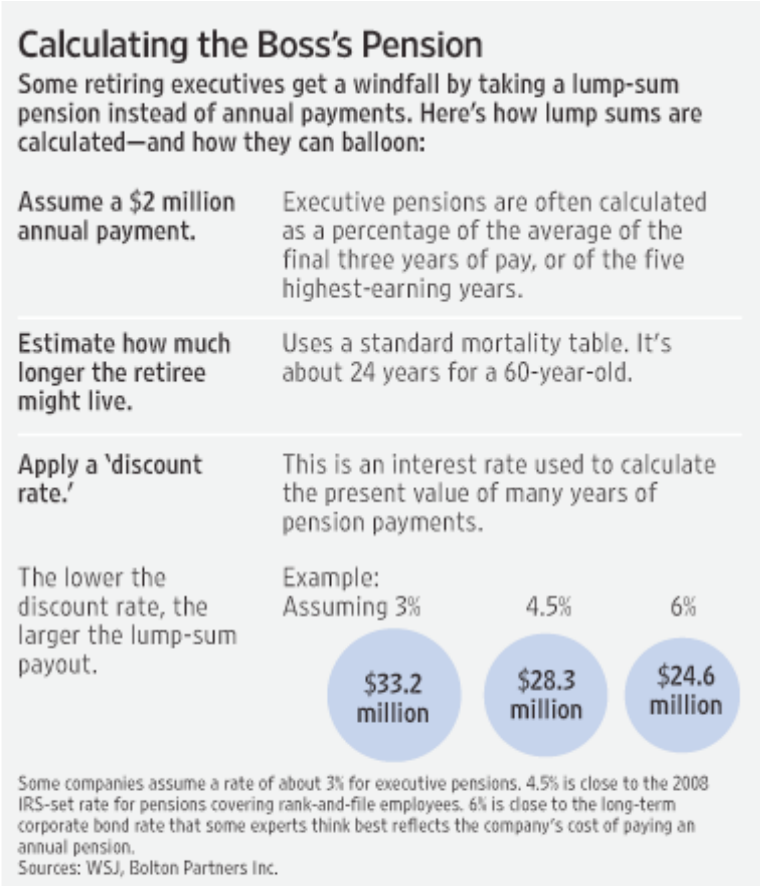
Because of the way they are regulated, executive pensions can carry risks for recipients that regular pensions don't. For instance, if an employer goes bankrupt, a retired executive usually becomes an unsecured creditor and may never see another dime in pension payments. By contrast, most regular pensioners are protected by the Pension Benefit Guaranty Corp., a federal body that insures retirement benefits to a certain level if a pension plan fails.

For reasons like these, many executives prefer to receive a lump sum. Some plans require them to do so.

To calculate a lump sum, a company-hired actuary first must figure out how long an executive is likely to live, based on a mortality table. Then a "discount rate," expressed as an interest rate, is used to calculate the current value of those years of future pension payments.

Here's where the hidden pension boost can come in. In theory, the interest rate should be linked to a market rate, in order to accurately value the lump sum at the time of retirement. But if the company picks an interest rate much lower than market rates, that results in a higher lump-sum payout to an executive. Because executive pensions are unregulated, companies are free to choose any interest rate.

Applying low interest rates can make a big difference. For example, for a 60-year-old male, the lump-sum value of that $2 million-a-year annual pension would be about $33 million using a 3% interest rate, and about $25 million using a 6% interest rate.



Compensation experts say some top executives try to build low lump-sum interest rates into their employment contracts. "From the executive's point of view, you're looking for the most favorable interest rate index you can get," says Robert Sedgwick, an attorney at Morrison Cohen LLP in New York who often represents top executives in pay negotiations.

Opinions differ on what interest rate would produce the fairest and most accurate payout for executive plans. But experts generally cite two: An Internal Revenue Service rate used in federally regulated plans, and a long-term corporate-bond rate. Many companies do use these rates for their executives.

The argument for the corporate-bond rate is that it represents what it would cost the company to fund the executive's annuity over the rest of his or her life. The IRS rate has the advantage of being the same one used for non-executive employees. The IRS rate, based on a complex formula, was roughly 4.6% to 4.7% last year. The Moody's Corp. long-term, AA corporate-bond rate is about 5.8%.

At McKesson, the 49-year-old Mr. Hammergren has no plans for retirement, according to a company spokesman. But had he quit or retired last March, he would have been entitled to a lump-sum pension of $84.6 million, the company's filings show.

That number -- among the highest for any U.S. executive -- was enhanced by a number of factors previously negotiated with the board. For instance, McKesson credits him with years he didn't serve, and also counts 150% of his annual bonus in the final pay calculation, instead of just the bonus he was actually paid.

McKesson disclosures, though technical, provide an unusual amount of detail about the way the company calculates Mr. Hammergren's lump-sum pension payout.

According to McKesson's 2008 proxy, Mr. Hammergren's lump-sum pension benefit as of last March was calculated using a 3% interest rate. For comparison, using instead the IRS rate in effect last March, Mr. Hammergren's lump sum would have been worth roughly $66.4 million. Using instead the 5.85% Moody's AA corporate-bond rate in effect last March, his lump sum would have been worth about $59 million, according to Bolton Partners Inc., an actuarial firm.

McKesson froze its traditional pension plan for ordinary employees in 1997, replacing it with a 401(k) plan in which the firm matches employee contributions with its own stock.

McKesson is among a number of companies that tie their executives' lump-sum payouts to an interest rate published by PBGC, the federal pension insurer. Using a government rate appears to provide an official imprimatur: McKesson's most recent proxy describes the rate as one "prescribed" by the PBGC for "the purposes of determining the present value of a lump-sum distribution on plan termination."

In fact, the PBGC has no authority over executive pension plans. Critics say the PBGC rate, based on a formula that dates to the 1970s, tends to be much lower than virtually any market interest rate, and so produces much larger lump-sum payouts. Over the past five years, the monthly PBGC rate has fluctuated from 2.25% to 4.75%. It's now at 3%.

The PBGC itself uses the rate only to value lump sums under $5,000, and says it considers the rate to be outmoded. The agency tried to stop publishing it several years ago, but reinstated it after some companies objected. The PBGC declined to comment on use of the rate to calculate executive lump-sum payments.

Using the PBGC rate to calculate executive pensions "borders on the scandalous," says Norman Stein, a pension-law professor at the University of Alabama at Tuscaloosa. "It's a gimmick to pay executives even more than the pension plan suggests they should be getting."

Not every company that uses the PBGC rate is significantly overpaying its pensions. Some, such as U.S. Steel, also use an older mortality table, which assumes that people don't live as long. That can offset some or even most of the effect of using a low interest rate.

Some companies tie their pension calculations to other relatively low interest rates besides the PBGC one. A few, such as United Technologies, use municipal-bond rates.

'Normal Approach'

A United Technologies spokesman called its formula a "typical, normal approach" for executive plans. He said half of recipients still choose annual payments, which wouldn't be the case if the lump sum were viewed as being more generous. He said United Technologies used a 3.7% interest rate to calculate Chairman George David's pension as of year-end 2007.

Dun & Bradstreet uses an interest rate pegged to 85% of the 15-year Treasury-bond yield. Company officials say the favorable rate dates back to the 1990s, when it was chosen to help compensate executives for an added tax bite on lump-sum distributions.

Some critics say the argument that executives might face a tax expense is correct, but overstated. Most executives receiving a big pension will have a sizeable tax bill no matter how the money is parceled out.

"There might be a bigger tax hit" with a lump sum, says James Verlautz, chairman of the pension committee at the American Academy of Actuaries. "Does that justify going from a 6% to a 3% rate? No."

Even as some companies give their executives favorable pension terms, there has been a movement toward less-generous terms for rank-and-file employees. In lobbying Congress a few years ago, big-business groups vociferously argued that the official rate then in effect -- the 30-year Treasury-bond rate -- was too low and should be replaced with the AA corporate-bond rate.

One major lobbyist was the American Benefits Council, which represents a few hundred major employers, including some, such as Hartford, that use the PBGC rate for their executives' pensions. In 2003, the group said the 30-year Treasury rate "artificially inflates lump-sum distribution calculations" and argued that the resulting oversized payouts "do not reflect the true value of a participant's benefit under the plan."

At the time, the 30-year Treasury rate was 4.7%, less favorable to retirees than the PBGC rate, then at 3%.

In the 2006 Pension Protection Act, Congress largely gave the American Benefits Council and other business groups what they wanted. The official lump-sum rate is set to change gradually by 2012, to a mix of corporate-bond rates that is expected to significantly cut lump-sum pensions for ordinary workers.

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