

PENSION MANAGEMENT RESEARCH PANEL

Healthcare Organizations Address the Future of the Defined Benefit (DB) Plan

EXECUTIVE SUMMARY

The **Pension Management Research Panel** recently conducted a Quick Poll of executives responsible for overseeing defined benefit (DB) plans for healthcare organizations in the United States. The poll was completed by a total of 73 organizations ranging from \$30 million to over \$1 billion in pension assets. None of the participants were institutional clients of SEI. The questions were designed to gain insight into the current status and long-term forecast for DB plans within this industry, the factors influencing decisions, and the alternatives being considered.

The healthcare industry has historically included DB pension plans as a critical part of employee benefits, however, like other industries they have, more recently, been forced to manage the pension's impact on corporate finances. As a result, the healthcare industry is no different than other industries judiciously reviewing the long-term future of this benefit.

Funding Levels Will Need to Improve

On an Accrued Benefit Obligation (ABO) basis, less than one-fifth of those polled are currently over 100% funded and more than one third are under 90% funded. Funding levels will need to improve under the Pension Protection Act (PPA) as the 100% requirement will be phased-in over the next several years.

Healthcare Defined Benefit Plans Remain Active for Now

More than two-thirds of the organizations polled said the DB plan is currently active and open to new hires. However, the necessity of this benefit to attract and retain healthcare employees is coming under question. Nearly a quarter of those considering a change felt this benefit is no longer as necessary as it once was.

Despite Active Plans, Changes Are Imminent

Although a majority of the healthcare organizations polled said the DB plan is currently active, more than

half said the organization is considering a design change. In fact, if the organizations considering freezing accruals actually do so, more than half of the pensions polled will have frozen accruals. Furthermore, two-thirds of those organizations intending to make a change said they plan on doing so by the end of next year.

Boards Are Pushing the Issue in Healthcare

When compared to other industries, more than three times as many healthcare organizations said the Board asking for an evaluation of the plan is their catalyst.

Pension Investments Causing Challenges

Approximately two-thirds of the healthcare organizations considering a change said they are doing so to eliminate or reduce investment volatility or reduce costs. These reasons were cited more than twice as much as any other reason for making a change.

Pensions Being Replaced by Other Benefits

More than half of the healthcare organizations polled are either considering or have already implemented enhanced matches in the Defined Contribution (401k, 401a, 403b, etc.) plan as an alternative to the defined benefit plan. About one-fifth said a cash balance plan is being considered as an alternative.

POLL RESULTS

What Type of Healthcare Organizations Participated in the Poll?

Participants selected the following descriptions of their organizations:

- 48% healthcare system consisting of multiple hospitals or clinics
- 47% stand-alone hospital or clinic
- 5% Hospital-affiliated educational program

How Funded Are DB Plans in Healthcare?

On an Accrued Benefit Obligation (ABO) basis, pension plans in healthcare are relatively well funded. However, beginning in 2008, the funding requirement will increase toward 100% for all plans. Where do healthcare organizations stack up given that requirement?

- 7% are under 80% funded
- 32% are between 81-90% funded
- 43% are between 91-100% funded
- 8% are between 101-110% funded
- 10% are over 110% funded

In addition, the majority (59%) of the organizations polled had between \$51-300 million in pension assets. 42% of the plans in that group are under 90% funded. All of the plans under 80% funded had \$300 million or less in assets.

What is the Current Status of Pension Plans in the Healthcare Industry?

When asked to provide the current status of the organization's pension plan, those polled responded:

- 67%: active and open to new hires
- 22%: currently closed to new hires, however current participants are still accruing benefits
- 10%: frozen, or currently closed to new entrants AND current participants are no longer accruing benefits but the termination process has not yet started
- Only one organization polled said they had started the termination process of the pension plan

What is the Funded Status of Frozen Plans in Healthcare?

According to the most recent analysis completed by the Pension Benefit Guaranty Corporation (PBGC),

more than 25% of all frozen pension plans were between 80-99% funded¹. In the same report, only 16% of the plans that were over 100% funded had frozen accruals.

Of the healthcare organizations participating in this poll, 100% of the plans that had already frozen accruals were between 81-100% funded. None of the plans over 100% funded had taken this action. However, it is worth noting that a high number of plans with a funded status between 81-100% could be on the verge of freezing accruals. 33% of all poll participants fell into that funding category AND were considering freezing accruals in the plan.

Are Healthcare Organizations Considering Plan Design Changes to the Pension?

All organizations polled were asked whether or not plan design changes were being considered:

- Only 44% said the plan will remain in its current state for the foreseeable future

Of those organizations considering changes:

- 49% said the organization is considering closing the plan to new entrants AND freezing accruals for current participants
- 24% said they are considering terminating the pension plan
- 27% said they are considering reducing benefits

How Soon Will Some of These Plan Design Changes Occur?

More than half of the healthcare organizations polled said they are considering a plan design change to the pension and many of them expect that if those changes take place, they will happen soon.

- 66% of those who are considering making a change to the DB plan, plan on doing so by the end of 2008
- 70% of those organizations considering freezing accruals anticipate doing so by end the of next year
- 49% of those organizations considering terminating the plan anticipate doing so by the end of next year

¹ "An Analysis of Frozen Defined Benefit Plans" Pension Benefit Guaranty Corporation (December 21, 2005)

Healthcare Systems Are Moving Away from DB Plans

Of healthcare systems consisting of multiple hospitals, only 15% said they are not currently considering changes to the defined benefit plan.

- 61% of the healthcare systems considering a change said the strategy they are considering is closing the plan to new entrants AND freezing accruals
- 50% said the organization anticipates making a plan design change before the end of 2008

In comparison, stand alone hospitals are more likely to stay with their current program:

- 35% of the stand alone hospitals considering a change said the strategy they are considering is closing the plan to new entrants AND freezing accruals
- 34% said the organization anticipates making a plan design change before the end of 2008

Boards Are Key Factors Influencing Plan Design Decisions

Boards appear to be having a much greater influence in healthcare than in other industries. In a more widely distributed poll conducted in late 2006, only 7% of 295 participating companies said that the Board asking for an evaluation was one of the reasons driving consideration of a plan design change.² These companies were representative of numerous industries across North America.

In comparison, of the 73 healthcare organizations participating in this poll, the percentage (22%) of respondents who said their Board was asking for an evaluation was three times higher than other industries. The Board seems to be even more influential in plans with \$300 million or less in assets as 28% of that group considering a change said the Board has asked for an evaluation.

Pension Investments Causing Challenges

Healthcare organizations have no shortage of reasons for considering changes to the defined benefit plan, but leading the way is the lack of control of investment volatility. When asked for the

reasons the organization is considering a change or made a change to the defined benefit plan:

- 48% said to eliminate or reduce investment volatility
- 47% said to eliminate or reduce costs
- 22% said the Board was asking for an evaluation
- 16% said it was no longer a necessity to attract or retain employees
- 10% said it was to standardize benefits across all employees

The need to eliminate or reduce investment volatility appears to be consistent among plans of all sizes. Below is a breakdown, based on size of plan, of the percentage of each group that cited investment volatility as a reason for considering changes:

- 58% with less than \$50 million in assets
- 50% with \$51-100 million in assets
- 53% with \$101-300 million in assets
- 60% with \$301-500 million in assets
- 38% with \$501 million to \$1 billion in assets
- 40% with over \$1 billion in assets

These results are particularly interesting given that plan design change, by itself, will have little or no impact on reducing or eliminating investment volatility. Plan design change must be a part of an overall evaluation of plan management including asset allocation studies.

What Alternatives to Pensions are Being Considered?

The transition away from defined benefit plans in healthcare appears to be underway. As organizations look to replace this retirement benefit, what is being considered as an alternative?

- 62% said the organization is considering or has already implemented enhanced matches in a Defined Contribution (401k, 401a, 403b, etc.) plan
- 25% said the organization is considering no replacement for the Defined Benefit plan
- 19% said the organization is considering or already has transitioned to a cash balance plan

Other options being considered or already implemented as an alternative to DB plans include age-weighted Defined Contribution (DC) allocation and enhancing profit sharing allocation.

² "The Future of Pensions" SEI Quick Poll (September 2006)

CONCLUSION

The results of this Quick Poll suggest that healthcare organizations are potentially in serious change mode when it comes to the defined benefit plans they currently manage. Investment volatility, unpredictable costs and Board questions and concerns are key drivers in the reevaluation of this benefit. The key understanding is that plan design changes are only one component of the long-term strategy around the pension plan – in most cases the problems don't simply go away overnight. In addition to considering design changes, many organizations are trying to find ongoing investment strategies that help control the volatility while providing the Board with a tolerable level of risk. Healthcare organizations are reviewing the overall management of the plan, determining if legacy management models are still the best options, and trying to find the most effective management model moving forward.



SEI's Global Institutional Group delivers integrated retirement, healthcare and nonprofit solutions to over 490 global institutional clients in seven different countries. SEI enables clients to meet financial objectives, reduce business risk, and fulfill their due diligence requirements through strategic advice integrated with Manager of Managers investment solutions for defined benefit plans, defined contribution plans, endowments, foundations and other balance sheet assets. For more information, email seiresearch@seic or visit our website at <http://www.seic.com/institutions>.

This information is for educational purposes only. Not intended to be legal and/or tax advice. Please consult your financial/tax advisor for more information. Information provided by SEI Investments Management Corp., (SIMC), a wholly owned subsidiary of SEI Investments Company.

©2007 SEI Investments Developments, Inc.