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Equity Research

19 January 2005
Americas/United States
Accounting & Tax

The Next Savings and Loan Crisis?

Q&A with the Head of the PBGC

- **The Pension Benefit Guaranty Corporation (PBGC) is the federal agency created in 1974 to protect defined benefit pension plans. Meanwhile, the PBGC could use some protection of its own, as its financial condition has taken a beating over the past few years. In fact, the PBGC recently announced the largest deficit in its entire history: $23 billion.**

- **The PBGC will soon take over US Airways' remaining pension plans, and it now faces the very real possibility of suffering the largest single loss in its history if United Airlines also dumps its pension plans onto the PBGC. Some, including Secretary of the Treasury John Snow, wonder whether the defined benefit pension system in the U.S. will turn into the next savings and loan crisis, with the U.S. government forced to step in and bail out the PBGC. In other words, the U.S. taxpayer (you and I) could be forced to cover the cost of failed pension plans.**

- **With the PBGC in bad shape and pension funding relief set to expire, we expect pension reform will be a hot topic in Washington, D.C., this year. The President's plan for reforming pension plans was laid out on January 10 and is based on three main principles: reform the funding rules, reform PBGC premiums, and increase disclosures. We expect the discussion and debate on pension reform to pick up steam this year.**

- **With that as the backdrop, we, along with many investors, have lots of questions for the PBGC, including: Are we facing the next savings and loan crisis? What are the biggest flaws in the pension system today? For how many more years can the PBGC continue to pay pension benefits? Could we see pension plans start shifting asset allocations toward fixed income? Where does the PBGC stand in line in a bankruptcy?**

- **To get the answers to these questions, among others, from the PBGC's perspective, we sat down with Brad Belt, the head of the PBGC, back in December, for his take on the current pension landscape. This report includes our questions along with his answers.**

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The Next Savings and Loan Crisis?

The Pension Benefit Guaranty Corporation (PBGC) is a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to (as its name would imply) protect defined benefit pension plans. Meanwhile, the PBGC could use some protection of its own, as its financial condition has taken a beating over the past few years. In fact, the PBGC recently announced the largest deficit in its entire history: $23 billion. The PBGC will soon take over US Airways' remaining pension plans, and it now faces the very real possibility of suffering the largest single loss in its history if United Airlines also dumps its pension plans onto the PBGC. Some, including Secretary of the Treasury John Snow, wonder whether the defined benefit pension system in the U.S. will turn into the next savings and loan crisis, with the U.S. government forced to step in and bail out the PBGC. In other words, the U.S. taxpayer (you and I) could be forced to cover the cost of failed pension plans.

With the PBGC in bad shape and pension funding relief set to expire, we expect pension reform will be a hot topic in Washington, D.C., this year. The first step down the path to pension reform in 2005 was taken on January 10 by Secretary of Labor Elaine Chao in a speech, "Protecting the Retirement Security of America's Workers: The President's Plan for Reforming Private Defined Benefit Pension Plans." The President's plan is based on three main principles: reform the funding rules, reform the premiums, and increase disclosures. We expect the discussion and debate on pension reform to pick up steam this year. There are a variety of other pension reform issues that we expect to be discussed this year, including enhancing the PBGC's status in bankruptcy and potentially easing the transition to hybrid pension plans (e.g., cash-balance plans).

With that as the backdrop, we, along with many investors, have lots of questions for the PBGC, including: Are we facing the next savings and loan crisis? What are the biggest flaws in the pension system today? For how many more years can the PBGC continue to pay pension benefits? Could we see pension plans start shifting asset allocations toward fixed income? Where does the PBGC stand in line in a bankruptcy?

To get the answers to these questions, among others, from the PBGC's perspective, we sat down with Brad Belt, the head of the PBGC, back in December, for his take on the current pension landscape. This report includes our questions along with his answers. In addition, we also dug through the PBGC Web site, www.pbgc.gov, to come up with some interesting facts and figures.

The Current Pension Landscape

Are we in the midst of a pension crisis?

- *This is a serious problem that needs attention. Fortunately, there is time to fix the system. Nobody should be deceived into thinking that it will be without cost, or that we can simply wait for things to turn around on their own. The system urgently needs three reforms: greater transparency, better funding, and risk-based premiums.*

How do you respond to those who try to downplay today's pension underfunding by highlighting the long-term nature of the pension obligation and plan assets?

- *We shouldn't confuse present liquidity with long-term solvency, as some would have us do. Fortunately, the long nature of most pension liabilities gives us time to develop and implement reforms that will lead to a healthy defined benefit pension system. That does not mean we should adopt a "wait and see" attitude.*

How do you respond to comparisons of the defined benefit pension system with the savings and loan crisis?

- *Some of the comparisons are quite apt. As was the case with the S&L crisis, the existence of a government guarantee creates a moral hazard and encourages unacceptable risk taking. In both instances, the regulatory systems are characterized by a lack a transparency. Further, measures taken to "buy time" have in fact made the situation worse. One significant difference is that the numerous instances of fraud and mismanagement that characterized the S&L crisis have not appeared in the case of pensions. Another difference is that pension plans, unlike many S&Ls, do not face an imminent liquidity crisis.*

Why do some companies suffer from pension problems today? Do these companies simply not understand the promises they are making?

- *Many of the decisions made by the firms involved are entirely rational in the context of the pension system as it exists today. The existence of the PBGC shields beneficiaries from the adverse consequences of underfunding and investment risk, the current accounting regime allows firms to claim the benefits of risky investments without fully acknowledging the cost, and the lack of risk-based premiums fails to discourage risky behavior. Companies have been given a free "put" to the federal government. We shouldn't be too surprised when they exercise it.*

Do you think that the heavy equity allocation in U.S. pension plans makes sense?

- *Sponsors should be able to invest pension assets as they deem appropriate, consistent with their fiduciary responsibilities. The key issue is whether the sponsor and its shareholders are willing or able to absorb the risk created by persistently mismatching assets and liabilities. For a healthy plan sponsor with a relatively small pension plan, the risk of such a mismatch is manageable. An unhealthy plan sponsor with a relatively large pension obligation may find the mismatch risk difficult to bear. Over the past few years the financial markets have become increasingly aware of this risk, and market discipline is beginning to play a role in asset allocation.*

Do you believe the pension plans played a part in causing the failures of steel companies? Did the legacy obligations become too big a weight to bear?

- *The decline of the old-line U.S. steel industry is primarily the result of structural changes in the economy and competition from domestic and international firms with lower costs and better business models. To be sure, pension underfunding and participant demographics played a role in the ultimate demise of certain steel companies, but the fault lies with poor long-term planning and failure to adequately fund the plans, not with the plans themselves. Dealing with large legacy obligations requires careful planning and prudent investment strategies. Unfortunately, when a company's situation becomes sufficiently desperate, the financial benefits of shedding unfunded pension obligations in the bankruptcy process makes "failure" seem like an attractive option to workers and management (if not shareholders).*

Was pension-funding relief a good idea? In particular, the extra special relief for the airlines and steel companies?

- *Pension funding rules need to be tightened, not relaxed. In particular, allowing the riskiest plan sponsors to avoid making needed contributions to their pension plans has directly increased the PBGC's exposure and expected loss. It does not appear that the relief granted to airlines has been effective in stabilizing their financial condition enough to reduce the risk that they terminate their pension plans.*

How is it possible for a company to avoid having to contribute to its pension plan yet its plan ends up significantly underfunded when it is terminated and dumped onto the PBGC?

- *Under the current funding rules, companies are able to follow the letter of the law without fully funding their pension plans. The most significant factor is the use of a "current liability" minimum funding standard that ignores the significant changes to payout assumptions that take place when a plan terminates. Credits for past funding, waivers from required contributions, and the inability to enforce funding rules in Chapter 11 are also factors in the often poor funded status of pension plans taken over by the PBGC.*

Looking Ahead

What are the biggest flaws in the pension system today? How would you propose to reform the pension system? What changes, if any, are on the way? Is the process too political to institute real pension reform?

- *The flaws are many: funding rules that don't ensure plans are well funded, premiums that don't cover expected losses or reflect risk, and lack of transparency. The administration has been working on a pension reform proposal for some time, and we expect to release the plan shortly. It will be difficult to reach consensus in all areas, but I think everyone involved in the defined benefit pension system realizes that the time for action is here. Some key aspects of the reform package are greater transparency for pension plans, adequate funding of benefit promises, and risk-based premiums for plan sponsors. In a narrow sense, there will always be "winners" and "losers" in a reform process, but I believe everyone recognizes that the current system is heading toward a costly breakdown that will benefit no one.*

How do you respond to threats that pension reform will result in companies bowing out of the defined benefit system, as their plans will become "too costly"?

- *I have two problems with the premise of the question. First is the notion that employers would "threaten" to leave the system. I assume that they have a DB plan because it is a useful employee recruitment and retention tool and is something valued by employees. Second is that reform will somehow make their plans "too costly." The cost of the plan is dictated by the company (or the company and a union in a collectively bargained context); it is the value of the pension benefits promised to employees. Appropriate reforms simply would accurately measure and disclose those costs, and require companies to keep the promises they have made. Perhaps what is implicit in the question is that current rules too easily enable companies to hide those costs, shift risks, and abrogate the promises they have made.*

Most investors hope they are long gone before the PBGC steps in, so why should they care about the health of the PBGC and a pension crisis? Does it have ramifications for the healthier companies (e.g., could we see higher premiums)?

- *Investors should care about the financial status of a company's pension plans. This isn't a case where ignorance is bliss. On the contrary, as some equity holders have learned to their chagrin, their ownership interest in the company can be wiped out when plans become substantially underfunded and contribute to a company entering bankruptcy. Even in less dire circumstances, equity owners need to understand that the funding requirements for a plan may absorb a significant amount of future earnings. And, bondholders should understand the impact of the pension fund on the overall balance sheet and credit worthiness of the company. This is really a matter of better disclosure, and it would be a step forward for the SEC to require that companies provide much more robust disclosure about the financial status of the pension plan and ERISA funding requirements. Even healthier companies with better-funded pension plans may be impacted as PBGC insurance premiums rise to reflect the greater level of risk in the system. A private insurer would be expected to raise premiums following large losses, and indeed such behavior is readily observable in the insurance market. The PBGC's premiums have not increased in over a decade despite the substantial losses incurred in recent years.* [Not surprisingly one aspect of the President's plan for pension reform is to increase PBGC premiums. For example, the flat rate premium that companies pay could rise from $19 per employee to $30 per employee.]

Many investors would be happy to see defined benefit plans go extinct, resulting in less risk for the companies they own; however, don't defined benefit plans offer advantages over other approaches to retirement finance?

- *It is wrong to say that defined benefit plans only add risk to a sponsoring firm. Well-funded, prudently managed defined benefit plans can be a source of strength by fostering employee retention and loyalty, and adding flexibility to the compensation process. Further, defined benefit plans offer participants some advantages in the form of professional investment management and mutualization of risk, plus, of course, the PBGC guarantee.*

How do you expect to deal with the large deficit that the PBGC is currently running?

- *Insurance premiums have been insufficient to compensate PBGC for past losses and future expected claims. Any viable insurance system has to provide enough revenues to meet claims over the long term. Given that PBGC's current premiums have not increased in more than a decade despite massive losses, additional premium revenue is clearly necessary.*

For how many more years can the PBGC continue to pay benefits? In other words, at what point in time will the PBGC run out of money?

- *The PBGC has sufficient liquidity to continue meeting its obligations for a number of years. Some independent researchers have attempted to forecast a future date at which the PBGC might exhaust its resources. Those projections are subject to tremendous uncertainty given the volatile nature of the pension insurance system. The PBGC's stochastic modeling does not forecast a cash exhaustion date but projects the agency's net financial position 10 years in the future. Under current law, there is only a very limited chance that the insurance program will return to surplus.*

Is the PBGC backed by the full faith and credit of the U.S. government? If not, what would happen if the PBGC could no longer afford to pay benefits?

- *The PBGC is not backed by the full faith and credit of the United States government. Instead, the pension insurance program is supposed to be self-financing. Under the current legal structure, the PBGC would be limited to drawing down its $100 million credit line with the U.S. Treasury before having to reduce or eliminate benefit payments. Most observers consider such an outcome unlikely because political pressure would force action to restore viability to the system. In my view, the sooner such reforms take place, the less painful they will be for everyone involved. That is one reason why the administration is focusing on pension reform now—so that we can deal with the problem before the cost of fixing it grows.*

In what ways can the premium structure be changed to better reflect the risk of each pension plan insured by the PBGC? Specifically, should the focus be on asset allocation in the pension plan versus the duration of the pension obligation, creditworthiness of the plan sponsor, or other factors?

- *The goal of risk-based premium pricing should be to balance the need to incentivize good behavior with the need to preserve some mutualization of risk. The objective is to identify which plans pose a high enough risk to warrant higher premiums. As with any insurance system, all participants must pay something. Asset allocation and other investment decisions are subject to the fiduciary obligations under ERISA. Company CEOs, CFOs, and investment managers should understand and be held accountable for the risks taken in pension plans and who bears the costs of those risks.*

What are your thoughts on pension accounting? Would a more transparent form of accounting allow companies to make more rational decisions about their pension plans?

- *The current accounting regime lacks transparency and, in my personal opinion, should be changed. Many observers have noted that the recent improvements to FAS 132 are a step in the right direction but do not go far enough to correct some obvious flaws. Smoothing of assets and liabilities provides investors with a distorted picture of a plan's true performance and volatility, and the use of expected return on assets allows firms to invest in riskier assets without recognizing the risk. Additionally, current accounting aggregates plans in the financial statements, making it difficult to identify individual plan underfunding. Companies should provide a more thorough discussion of pensions in the MD&A of their annual and quarterly reports. Information of which management is aware and that will be of material interest to investors is required to be disclosed. That will certainly be the case for companies with severely underfunded plans and large contributions owed.*

How do you respond to threats that a change in the accounting to a mark-to-market type approach would result in companies shutting down their defined benefit plans?

- *As noted above, I find troubling the notion that providing accurate, timely information about the financial status of the pension plan would cause a company to freeze or terminate the plan. Obfuscation is not the solution to the problems afflicting the defined benefit plan system.*

Do you think that pension plans could start shifting more assets toward fixed income as a result of a number of potential trends (e.g., demographics, pension reform, a change in the accounting)?

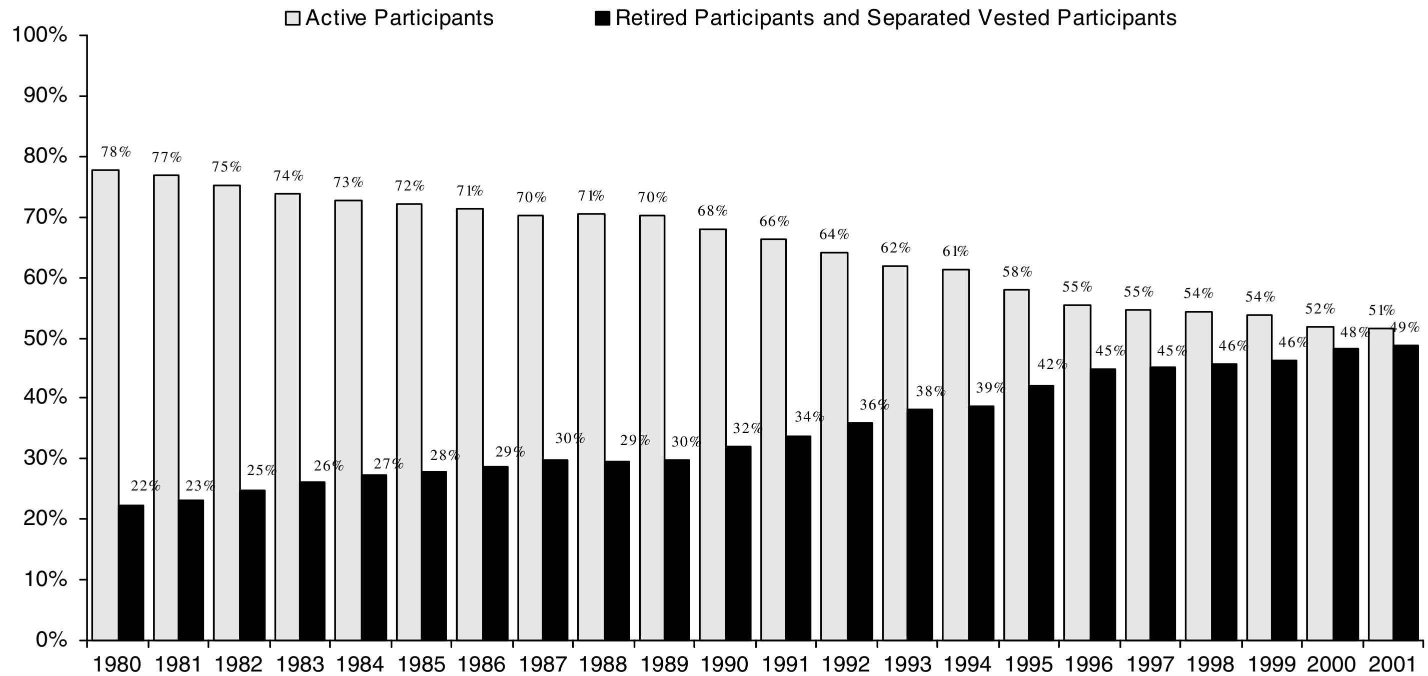
- *Again, this is a decision that has to be made by the company. I would note that the demographic shift toward older pension plan participants will have the outcome of shortening liability durations. As liability durations decline, equity assets—highly volatile with higher long-term average returns—have less time to achieve their expected returns and have a greater chance of leaving plans short. Similarly, a change to fair value accounting, which would force plans to recognize the risk of their investment portfolios and their liabilities, may tend to increase the demand for more stable fixed-income assets that provide a better hedge to liability performance.*

Should investors be concerned about the trend toward more retirees than active employees in pension plans?

- *Across the economy, this trend is a reflection of many factors, including increasing longevity and the slower growth of many industrial sectors that were commonly associated with defined benefit plans. On a company-specific basis, such a trend would indicate that the plan is capable of exerting an increasing influence on the finances of the sponsoring firm. The PBGC's experience in such cases suggests that the key variable, as always, is the degree of underfunding.*

The trend toward more retirees than active employees in defined benefit pension plans is depicted in Exhibit 1, which shows the breakdown between retirees and actives in PBGC insured pension plans. In 1980, active employees represented 78% of the participants in pension plans insured by the PBGC; by 2001, actives accounted for only 51% of the participants.

Exhibit 1: Actives versus Retirees in PBGC-Insured Plans, 1980–2001



Note: Data is for Single-Employer Plans. "Separated Vested" refers to employees that have vested (i.e., guaranteed) pension benefits from a firm but are no longer employed by that firm.

Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

How does the PBGC envision its future role as more and more companies move away from defined benefit plans?

- *We believe that the defined benefit plan should remain a viable option for participants and plan sponsors. The traditional "final average salary" concept of a defined benefit plan will be challenged in an era of greater job mobility, but so-called hybrid designs may prove viable over the long term. As these are defined benefit plans insured by the PBGC, its role as insurer may continue for quite some time.*

What lessons has the PBGC learned from the steel companies?

- *The most obvious lesson is that when an industry is populated with a number of large, older firms with substantial pension obligations, newer, lower-cost competition can put tremendous pressure on plan sponsors. Over the past two decades, low-cost domestic and foreign competition drove many older U.S. steel manufacturers out of business. Once these liabilities were transferred to the PBGC, much of the productive capital in the industry came back on line. A similar situation seems to be playing out in the airline industry as the low-cost carrier model gains market share against the major carriers. We are taking a more aggressive stance in the restructuring process and will aggressively fight attempts to dilute the risk-sharing principles of the pension insurance system, for example, by closely scrutinizing "follow-on" plans that are established after a company has transferred liabilities to the PBGC.*

Clearly, defaults at airlines and steel companies have resulted in significant losses for the PBGC. What other industries may pose significant risks for the PBGC in the future?

- *As a general matter, we focus on companies with significant levels of underfunding that are also credit risks. Historically, we've found those to be conflated in mature industries with unionized work forces and high labor costs that are facing competitive and structural pressures.*

The criteria that the PBGC uses to classify a company as a reasonably possible exposure to loss include: the company is in Chapter 11; has received or requested a funding waiver from the IRS; has missed a minimum contribution to the pension plan; has a credit rating below investment grade; or has no credit rating but the ratio of long-term debt plus the amount the pension plan is underfunded to market cap is 1.5 or higher. In Exhibit 2, we include the six sectors that made up the $95.7 billion in reasonably possible loss exposure for the PBGC at the end of 2004. Note that manufacturing companies account for half the total.

Exhibit 2: PBGC's Reasonably Possible Exposure to Loss by Sector (Principal Categories)

US$ in millions

	FY 2004	FY 2003
Manufacturing	$48,444	$39,470
Transportation, Communication and Utilities	30,480	32,937
Services/Other	7,926	2,501
Wholesale and Retail Trade	5,806	4,346
Agriculture, Mining and Construction	1,866	1,762
Finance, Insurance, and Real Estate	1,151	1,079
Total	$95,673	$82,095

Source: Pension Benefit Guaranty Corporation, Performance and Accountability Report (2004).

What would stop other industries from following the lead of the steel companies, dumping their pension plans on the PBGC and relieving them of a massive legacy obligation while leaving the PBGC holding the bag?

- *I would note that there is a statutory process with specific criteria that must be met before plans can be terminated and transferred to the PBGC. The desire simply to be more competitive is not one of the criteria. For managers a number of other obstacles exist, including the need to wipe out the interests of shareholders (in bankruptcy), taking on their employees by seeking to abrogate their collective bargaining agreements, and losing control over their own future.*

Do you have any final observations for investors who are alarmed at the recent headlines about the defined benefit pension system?

- *A strong defined benefit plan can be a source of strength to a plan sponsor, just as a weak defined benefit plan can ultimately harm its sponsoring company. It is important to consider the relationship between the pension plan and the sponsor company very carefully. For many defined benefit sponsors, the performance of the pension plan is at least as important, and in some cases more important, as the company's core operations. Understanding the funded status of the pension plan, its investment strategy, and the pace of future contributions should be the investor's focus.*

Monitoring the Health of Pension Plans

How does the PBGC monitor the pension insurance system and identify risk before plans terminate? What actions can the PBGC take to protect itself from such risk?

- *The PBGC tracks plan sponsors that have the potential to pose significant risks to the pension insurance system. The goal is to identify instances where financial conditions or other factors, such as mergers, asset sales, or similar transactions, may increase the risk of long-term loss. The PBGC is limited in its ability to respond in such situations, with the most tangible option being the most serious: involuntary termination of a plan. We don't use the threat of involuntary termination lightly, but it does provide an effective tool for bringing a plan sponsor to the table for negotiations. The reason it can be effective is that, among other things, it imposes a liability for the full amount of underfunding on the plan sponsor and members of the sponsor's controlled group. In many cases, given the amount of underfunding, the company would trigger covenants in its debt agreements.*

What is a 4010 filing? When are companies required to file one and what type of information is obtained?

- *Companies whose pension plans are underfunded in excess of $50 million dollars must file a 4010 report with the PBGC. In addition, plans with an outstanding minimum funding waiver or a missed contribution must also report. The filing contains corporate financial information and plan information, including the market value of plan assets and the value of plan benefit liabilities calculated on a termination liability basis. The PBGC has recently begun developing a system to allow companies to provide this information electronically. Under current law, information filed with the PBGC under section 4010 of ERISA cannot be publicly released. We are seeking ways to broaden the disclosure of this information in order to enhance the transparency of the pension system.*

How many companies currently file a 4010 report with the PBGC? What percentage of the total defined benefit pension system underfunding do these companies account for?

- *Approximately 400 companies file 4010 reports with the PBGC. This is clearly material information, as the total amount of underfunding for these companies at the end of 2003 was about $280 billion (80% of the estimated $350 billion total underfunding).*

If a company has difficulty meeting its funding requirements, does the PBGC get involved?

- *Plan sponsors having difficulty in making required pension funding payments may petition the IRS for a waiver. Although the IRS is directly responsible for the decision, in practice it works closely with the PBGC to determine if such a waiver would pose undue risk to the system, and if not, what terms should be applied.*

Can a company decide that it will not make a required contribution to its pension plan? Is there a penalty for doing so? Even in bankruptcy?

- *ERISA and the tax code provide that companies must make required contributions. If a plan sponsor fails to make a required contribution(s) of more than $1 million, the PBGC is able to perfect a lien against the assets of the plan sponsor and members of the sponsor's controlled group, equal to the value of the missed payment. However, if a company is in bankruptcy, the automatic stay prevents the PBGC from enforcing such a lien.*

Terminating a Pension Plan

A pension plan can be terminated in three ways: distress termination, involuntary termination, and standard termination. We briefly walk through each:

Distress termination. A company can terminate an underfunded pension plan if it can prove that it's suffering from severe financial distress. How does a company prove that it is under severe financial distress? By meeting at least one of the following criteria:

- The company filed for Chapter 7 liquidation in bankruptcy.
- The company filed for Chapter 11 reorganization in bankruptcy, and the bankruptcy court has determined that the company will not be able to reorganize with the pension plan intact and approves plan termination.
- The company can't continue in business unless the pension plan is terminated.
- The costs of providing the pension plan have become unreasonably burdensome as a result of a decline in the number of employees covered by the plan.

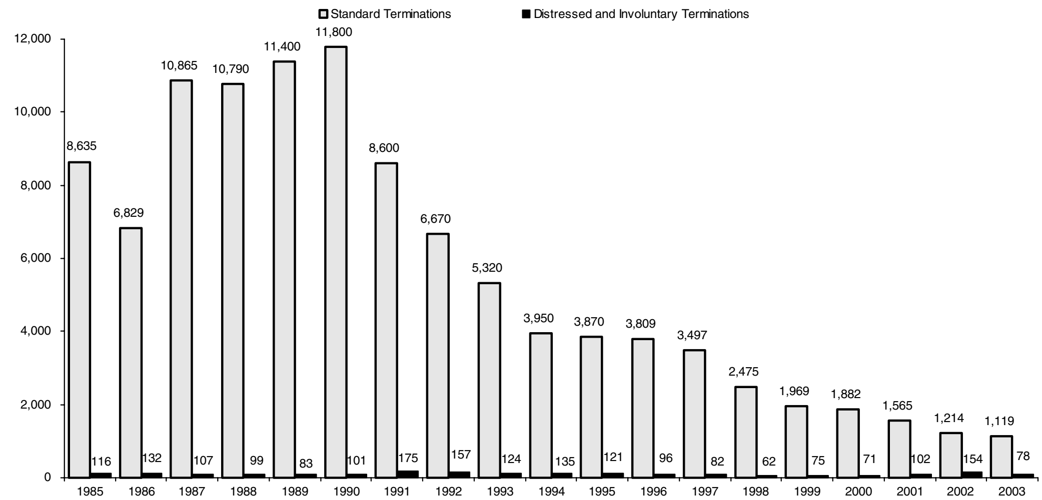
With a distress termination, the PBGC assumes the pension obligation (up to a guaranteed maximum) and takes over the pension plan assets.

Involuntary termination. The PBGC can terminate a pension plan even if the company has not filed to terminate the plan as long as certain criteria are met, which the PBGC elaborates on in the answer to a question below. With an involuntary termination, the PBGC assumes the pension obligation (up to a guaranteed maximum) and takes over the pension plan assets.

Standard termination. A company can terminate a pension plan if the plan is fully funded or overfunded and a number of administrative steps are taken. With a standard termination, the company is settling the pension obligation by either buying an annuity contract or paying a lump sum to the pension plan participants.

Over 167,000 pension plans in the U.S. have been terminated over the course of the PBGC's history (through 2003); 164,067 of the terminations have been standard terminations, while only 3,277 were either distressed or involuntary. The yearly pension plan terminations from 1985 through 2003 are included in Exhibit 3.

Exhibit 3: Pension Plan Terminations, 1985–2003



Note: Data is for Single-Employer Plans.
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

With a distress termination, how does a company prove its business can't continue or pension costs are unreasonably burdensome? What could cause an application for distress termination to not be granted to a company?

- *It must demonstrate that it could not emerge from bankruptcy while maintaining its plans. And, it must demonstrate this on a plan-by-plan basis. There are various standard cash flow and credit metrics that the PBGC and a bankruptcy court would typically consider in doing this analysis.*

Under what circumstances would the PBGC decide to terminate a pension plan before the company terminates it (an involuntary termination)? How often has this happened?

- *The law provides that the PBGC may terminate a pension plan if the plan has not met the minimum funding requirements; the plan cannot pay current benefits when due; a lump-sum payment has been made to a participant who is a substantial owner of the sponsoring company; or the loss to the PBGC is expected to increase unreasonably if the plan is not terminated. The PBGC must terminate a plan if assets are unavailable to pay benefits currently due.*

Does the PBGC try to settle the obligation it assumes when it takes over a pension plan by paying a lump sum or purchasing an annuity that will pay benefits in the future after the participant reaches retirement age?

- *That has not been the PBGC's practice. When an underfunded plan terminates, the PBGC assumes both the assets of the plan and the liabilities, which are paid out (up to statutory benefit limits) over the retired life of the participant. The PBGC does not allow participants to take their benefits in lump-sum form (except for benefits with a present value of less than $5,000), nor at this time does the PBGC purchase annuities from private insurers to cover the future benefits of plan participants.*

Bankruptcy and the PBGC

Why wouldn't a company terminate its pension plan in bankruptcy?

- *The law does not allow a company to terminate its pension plan solely because it is in Chapter 11. The company must demonstrate that the cost of maintaining the pension plan is too high to allow the company to emerge from bankruptcy or continue in business. The PBGC generally opposes plan terminations if the company will have the ability to support its pension obligations after the completion of a restructuring. This issue is ultimately litigated in bankruptcy court. In addition, an existing collective bargaining agreement may prevent a company from terminating a plan.*

How strong have PBGC efforts been to recover funds from companies? What types of efforts? How successful have they been? After bankruptcy, can the PBGC end up with a piece of the company?

- *The PBGC pursues all claims in bankruptcy vigorously, and in certain cases we have retained bankruptcy restructuring advisors to assist us in the process. Typically, the PBGC's claim for plan underfunding is treated as a general unsecured claim in bankruptcy. Although our average recovery is usually quite small in relation to the size of our claim, in certain cases we have received substantial value from the process, including equity in a reorganized company.*

Where does the PBGC stand in line in a bankruptcy? Where does the pension plan stand?

- *The PBGC's claim against the plan sponsor for plan underfunding ranks alongside other unsecured creditors in a bankruptcy. This claim is equal to the value of liabilities, calculated on the basis of the group annuity market, less the market value of the assets in the pension plan determined as of the date of plan termination. A plan's claims against the sponsor for any missed contributions can receive higher priority treatment in bankruptcy.*

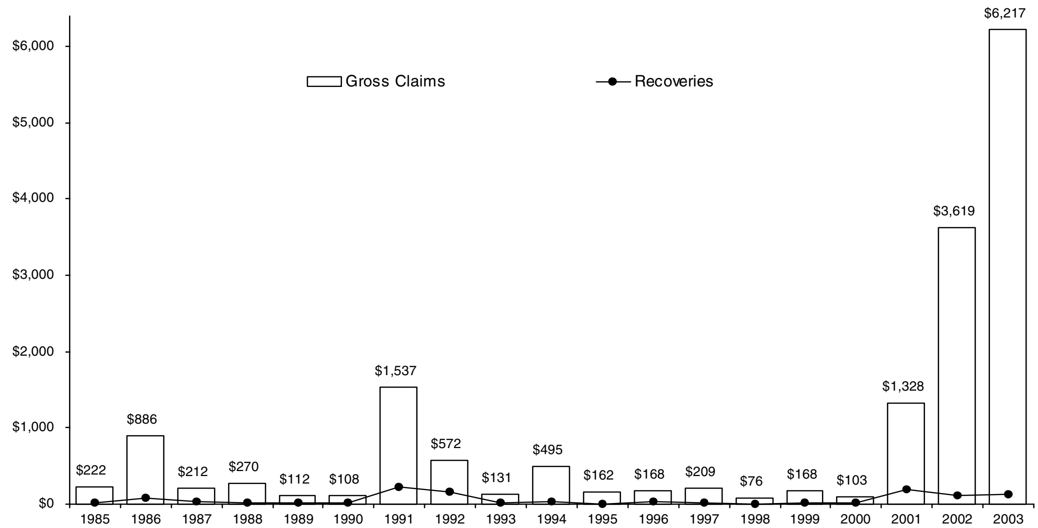
On average, how much of each dollar of plan underfunding and unpaid contributions has the PBGC been able to recover in bankruptcy?

- *Historically, the PBGC's recoveries on its claims for plan underfunding in bankruptcy have been less than 10 cents on the dollar.*

Prior to 2004, the PBGC has had $17.6 billion in total claims on terminated single-employer pension plans. It has recovered only $1.3 billion, or 7.5% of that total. Exhibit 4 shows the PBGC's claims and recoveries in each year from 1985 through 2003. Note the jump in claims over the past couple of years; in fact, the PBGC's $9.8 billion in claims from 2002 and 2003 combined were greater than all of the PBGC's claims in its prior 27 years of existence.

Exhibit 4: PBGC Gross Claims and Recoveries, 1985–2003

US$ in millions



Note: Data is for Single-Employer Plans.
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

Does the PBGC generally have a claim only on assets of the entity that sponsored the pension plan and declared bankruptcy, or could the PBGC have a claim on related entities?

- *Under ERISA, the PBGC has a claim for joint and several liability against all of a plan sponsor's controlled group members. Thus, the PBGC is able to assert a claim against the assets of a company's controlled group that remain outside of bankruptcy. This joint and several liability has provided a useful tool in enhancing the PBGC's ultimate recoveries in certain cases.*

Would you like to see the PBGC's status in bankruptcy enhanced? Is this one possible route that pension reform might take?

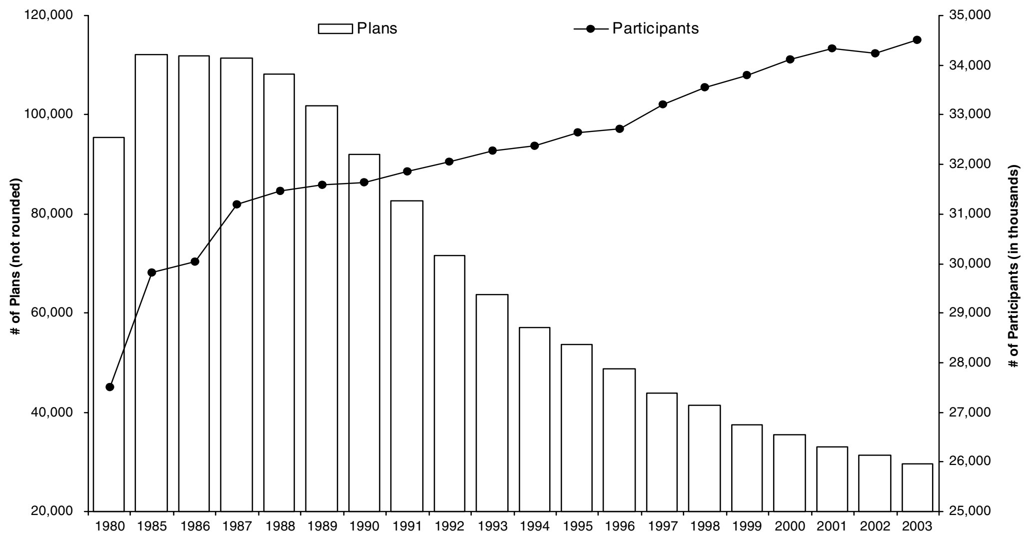
- *For the most part, the PBGC is a general unsecured creditor in bankruptcy. Moreover, in contrast to other stakeholders, the PBGC is an involuntary creditor. No one is suggesting that the PBGC should move to the head of the line, but a stronger position in bankruptcy would better protect the interests of the pension insurance program. Going forward, this would provide lenders with an incentive to draft covenant protections to ensure that companies fully fund their plans, so they wouldn't have to worry about a PBGC claim in the event of bankruptcy.*

The PBGC's Background

The PBGC was created by ERISA in 1974. It insures the defined benefit pension plans of more than 44 million workers and retirees in over 31,000 pension plans (both single-employer and multiemployer plans). Its mission is to encourage the growth of defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum.

The number of pension plans insured by the PBGC has dropped significantly over the past 20 years; however, the number of participants in PBGC-insured plans has continued to rise over the same time frame. We can see this clearly in Exhibit 5, where we focus only on single-employer pension plans; note the drop in the number of plans from a peak of 112,208 in 1985 to 29,512 in 2003, while the number of pension plan participants increased from 29.8 million in 1985 to 34.5 million in 2003.

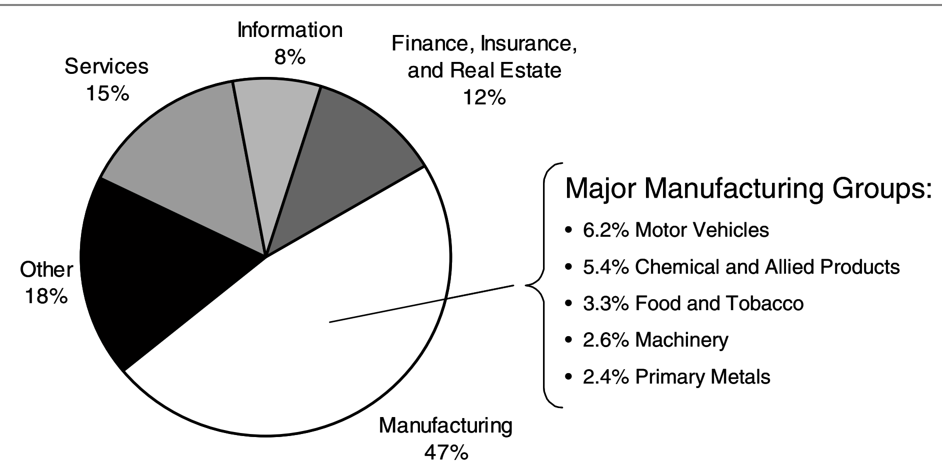
Exhibit 5: PBGC-Insured Plans versus Participants, 1980–2003



Note: Data is for Single-Employer Plans.
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

In Exhibit 6, we find that most of the participants in PBGC-insured pension plans are concentrated in just a handful of sectors; for example, nearly half of all covered single-employer pension plan participants are in plans sponsored by manufacturing firms.

Exhibit 6: PBGC-Insured Participants by Sector, 2002



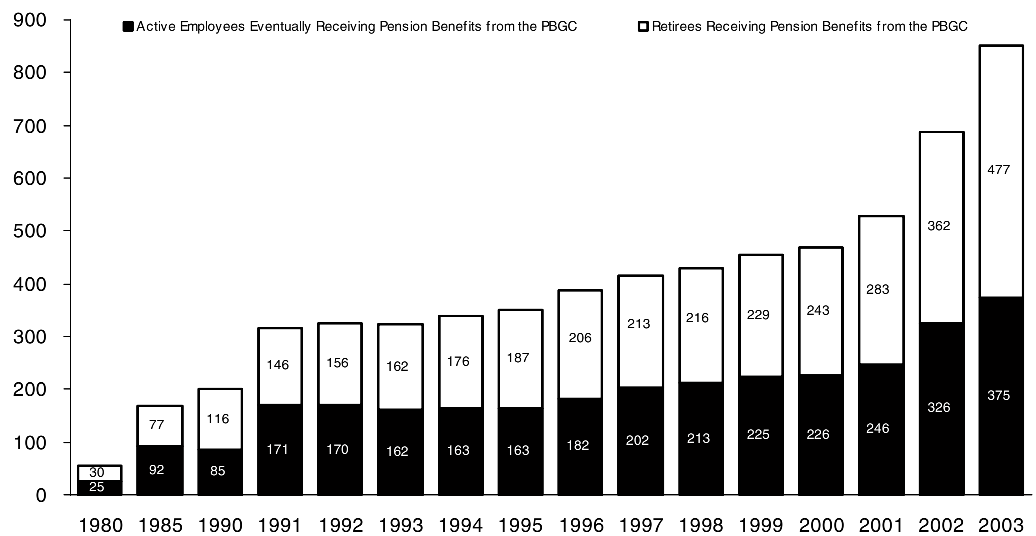
Note: Data is for Single-Employer Plans.
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

The PBGC has over 800 federal employees who are led by Brad Belt. Brad has been the head of the PBGC since April 2004. He reports to the PBGC's board of directors, consisting of the Secretaries of Labor, Commerce, and Treasury, with the Secretary of Labor as Chairman.

Currently, the PBGC pays pension benefits to over 500,000 retirees in nearly 3,500 pension plans that have been terminated, including those who have not yet retired; the PBGC is responsible for the current and future pensions of more than 1 million people. In **Exhibit 7** we chart the number of retirees from single-employer pension plans receiving pension benefits from the PBGC from 1980 through 2003 and the number of active employees that will eventually receive pension benefits from the PBGC. Notice the dramatic jump in those receiving pension benefits from the PBGC over the past few years, more than doubling from 229,000 in 1999 to 477,000 in 2003.

Exhibit 7: Participants and Beneficiaries Receiving PBGC Payments, 1980–2003

# of participants in thousands



Note: Data is for Single-Employer Plans.
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

In what ways does the PBGC differ from a typical insurance company?

- *The PBGC is both a financial guaranty insurer, which is most analogous to a provider of catastrophe risk insurance, and an annuity provider, which is most analogous to a traditional life insurance company. The most important difference between the PBGC and a private insurance company is that the PBGC is required by law to provide insurance to defined benefit plans without regard to their level of underfunding or risk of failure, and cannot independently adjust premiums to properly reflect the cost of that insurance. Also, the PBGC is not subject to the reserve and capital standards used in the private, regulated insurance industry. This effectively allows the PBGC to continue operating in a financial condition that in the private sector would be considered insolvent.*

The PBGC's Sources and Uses of Funds

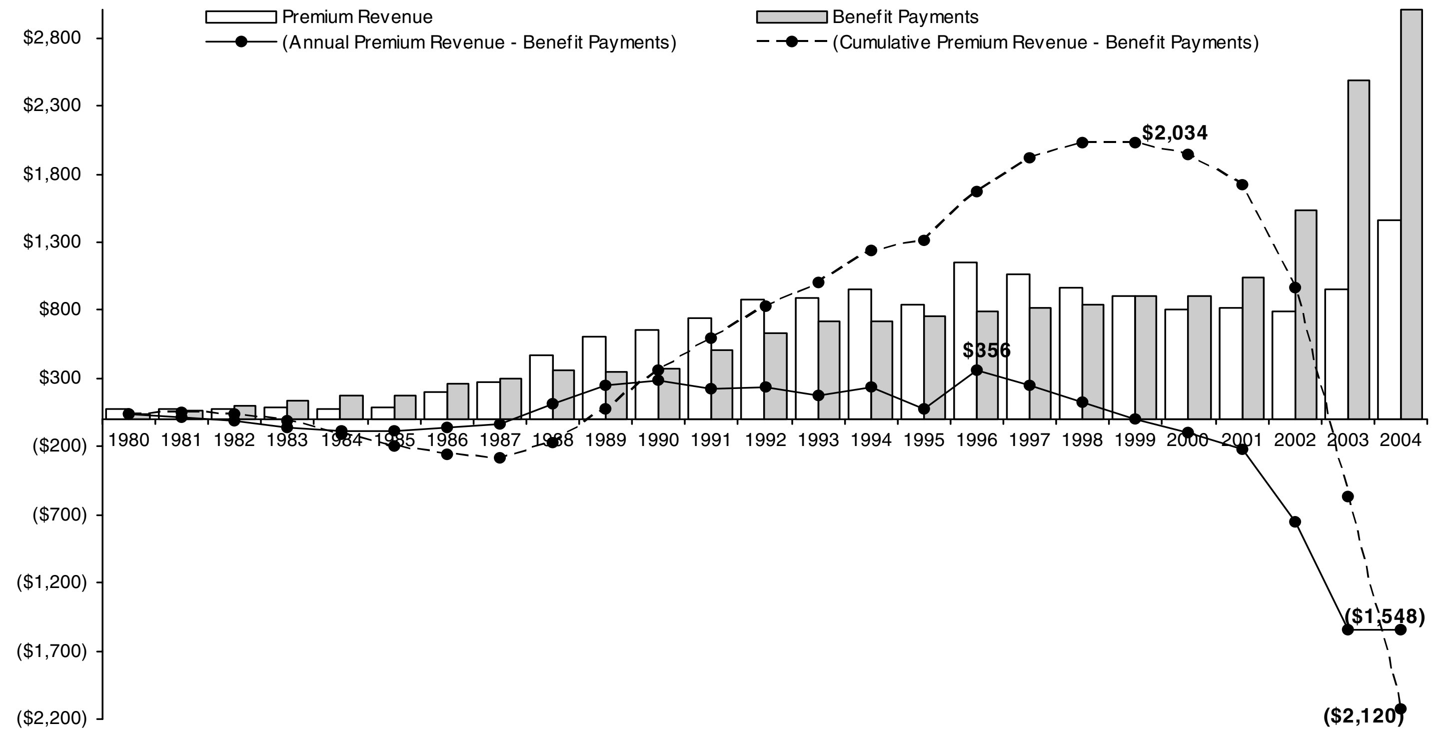
The PBGC receives no federal tax dollars. Instead, it has four main sources of funds: the assets of terminated pension plans, investment returns, claims against companies that terminated underfunded pension plans, and the annual insurance premiums that it collects from companies that offer defined benefit pension plans. The premiums are set by the U.S. Congress and have not changed since 1991. Companies currently pay $19 per employee or retiree plus $9 for each $1,000 the pension plan is underfunded (using a vested benefit obligation). For the year ended September 30, 2004, the PBGC's premium revenue from single-employer pension plans was $1.5 billion, up from $948 million in 2003.

The PBGC uses these funds to pay pension benefits to the retirees in the pension plans that it has taken over; it paid out $3 billion in benefits during fiscal 2004, up from $2.5 billion in 2003. The PBGC pays pension benefits to retirees up to a maximum amount set by law. For pension plans terminating in 2005, that maximum amount is $45,614 per year for those who retire at the age of 65. The guarantee is lower for those who retire early and higher for those who retire after the age of 65. For example, if you retire at the age of 55, the maximum amount is only $20,526 per year, versus $138,666 per year for someone retiring at 75.

From 1980 through 1999, the PBGC's cumulative premium revenue for single-employer pension plans was over $2 billion greater than the cumulative pension benefits that it paid over the same period. In other words, the PBGC was able to pay pension benefits to the retirees of the pension plans that it had taken over solely from the premiums that it had collected. The PBGC can no longer make that claim; over the past five years, the PBGC has reported $4.8 billion of premium revenue as compared with $8.9 billion in benefits paid. Therefore, over the past 25 years, the PBGC has had cumulative premium revenue of $15.9 billion as compared with benefits paid of $17.9 billion, a $2 billion shortfall. That pattern is not expected to change any time soon, as benefits paid are projected to continue growing, and the PBGC's premiums are not expected to keep up the pace (unless pension reform takes place). In Exhibit 8, we compare the PBGC's premium revenue to the benefits that it paid out from 1980 through 2004.

Exhibit 8: PBGC Premiums and Benefit Payments, 1980–2004

US$ in millions



Note: Data is for Single-Employer Plans.

Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003) and Performance and Accountability Report (2004).

The PBGC's Financial Condition

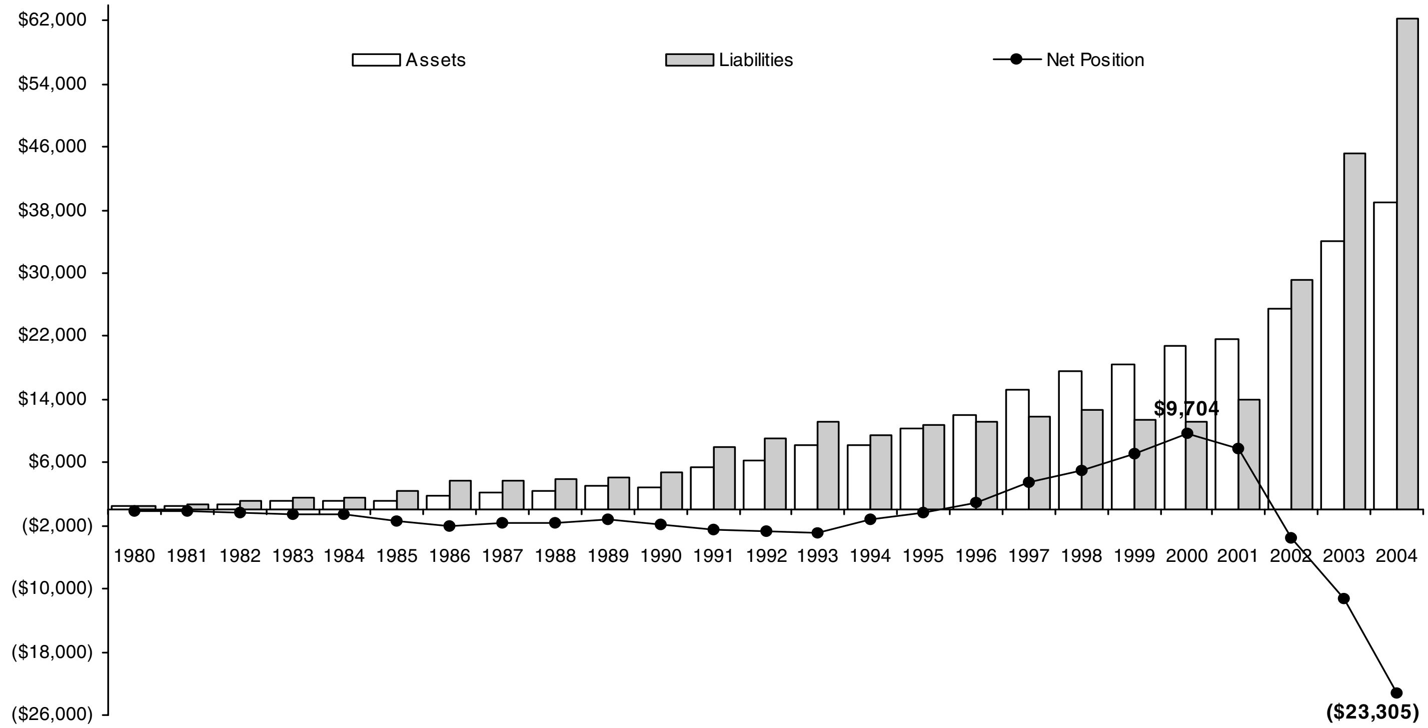
What is the PBGC's current financial condition, and how does it compare with previous years?

- *The financial condition of the PBGC's single-employer program deteriorated significantly in fiscal 2004 despite healthy investment income and increasing premium revenue. The corporation's net position worsened to a deficit of $23.3 billion from a deficit of $11.2 billion at fiscal year-end 2003. The primary causes for the deterioration were a $14.7 billion loss from completed and probable pension plan terminations and a $1.5 billion charge for actuarial adjustments due to a change in mortality assumptions. Partially offsetting these losses were premium income of $1.5 billion and investment income of $3.2 billion.*

In Exhibit 9, we map out the financial condition of the PBGC's single-employer program over the past 24 years. At its peak in 2000, the PBGC had $20.8 billion in assets supporting an $11.1 billion liability, for a net surplus of $9.7 billion. That surplus has since evaporated. Now the PBGC has $39 billion in assets supporting $62.3 billion in liabilities, leaving the PBGC in the worst financial condition in its history with a $23.3 billion deficit.

Exhibit 9: PBGC Assets, Liabilities, and Net Position, 1980–2004

US$ in millions



Note: Data is for Single-Employer Plans.

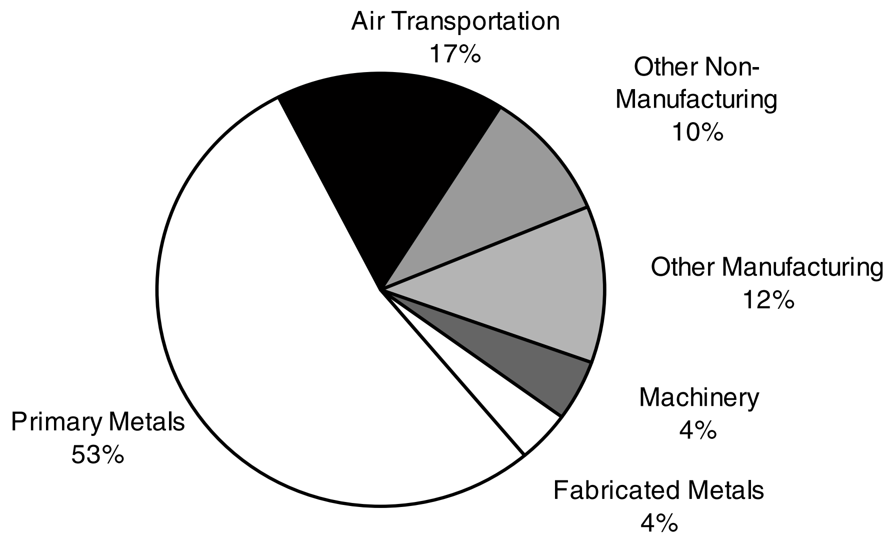
Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003) and Performance and Accountability Report (2004).

Which sectors have caused the most pain for the PBGC? What portion of PBGC losses have come from companies rated below investment grade?

- *Historically, the PBGC's largest losses have been in the steel and air transportation sectors, a trend that continued in 2004. The bulk of the PBGC's other claims have come from a range of manufacturing sectors, including metal products, machinery, textiles, auto parts, and so forth. When the PBGC recently examined the credit history of 27 of our largest claims, we found that none had been rated above junk within three years before plan termination and nearly 90% were junk rated 10 years prior to plan termination.*

In Exhibit 10, we find that over its entire history about 70% of the PBGC's $17.6 billion in claims have come from two industry groups, Primary Metals (53%) and Air Transportation (17%).

Exhibit 10: PBGC Claims by Industry, 1975–2003



Note: Data is for Single-Employer Plans.

Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

In Exhibit 11, we find that the largest PBGC claims have also been concentrated among a handful of companies. In fact, the top 10 largest claims have accounted for 61% of the PBGC's total claims. Two companies' pension plans—Bethlehem Steel and LTV Steel—represented 32% of all PBGC's claims.

Exhibit 11: PBGC Top 10 Claims, 1975–2003

Top 10 Firms	# of Plans	Claims by Firm	% of Total Claims
1. Bethlehem Steel	1	$3,650,276,601	21%
2. LTV Steel	5	1,849,498,808	11%
3. National Steel	7	1,216,107,871	7%
4. Pan American Air	3	841,082,434	5%
5. US Airlines Pilots	1	753,687,525	4%
6. Trans World Airlines	2	710,513,624	4%
7. Eastern Air Lines	7	552,730,569	3%
8. Wheeling Pitt Steel	7	495,235,029	3%
9. Polaroid	1	357,019,849	2%
10. Sharon Steel	5	290,787,636	2%
Top 10 Total	39	$10,716,939,946	61%
All Other Total	3,238	6,871,259,007	39%
TOTAL	3,277	$17,588,198,953	100%

Note: Data is for Single-Employer Plans.

Source: Pension Benefit Guaranty Corporation, Pension Insurance Data Book (2003).

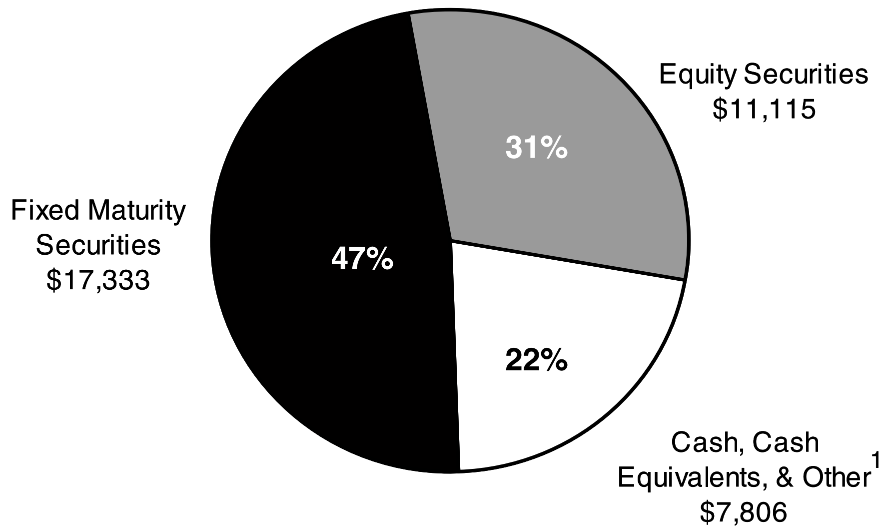
What is the PBGC's asset allocation?

- *The PBGC's investments are divided into two basic categories. Premium income is invested in long-duration U.S. Treasury securities. Assets of terminated plans are pooled in the PBGC's Trust Fund and are invested in a range of liquid securities described in the investment policy—basically U.S. equity and fixed income, real estate, and derivatives. Currently, the PBGC has approximately 70% of assets in cash and fixed-income securities and 30% in equity.*

The asset allocation in the PBGC's single-employer plan as of September 30, 2004, is laid out in Exhibit 12.

Exhibit 12: PBGC Asset Allocation, as of September 30, 2004

US$ in millions



Note: Data is for Single-Employer Plans.
[1]Other includes real estate and real estate investment trusts and other investments, which in total represent less than 1% of the portfolio.
Source: Pension Benefit Guaranty Corporation, Performance and Accountability Report (2004).

What was the rationale for the PBGC's recent shift in asset allocation toward fixed income? How has that been accomplished?

- *The PBGC's financial condition has experienced tremendous volatility over the past few years, resulting not only from the recent surge in plan terminations, but also from the performance of the PBGC's assets and the impact of interest rates on the PBGC's liabilities. The PBGC's on-balance-sheet liabilities are fixed annuities that are bond-like in nature, while the PBGC's assets are allocated to both bonds and stocks. Under the previous investment policy the entire Trust Fund was allocated to U.S. equities, with the result that the mismatch between assets and liabilities was growing as the Trust Fund grew with newly trusteed assets. Over time this trend would have worsened the PBGC's asset-liability mismatch and increased balance-sheet volatility. In addition, the PBGC is already heavily exposed to equity risk, as the plans we insure tend to have a high equity allocation. In response, the PBGC's board of directors approved a new investment policy in early 2004 that identifies as a core objective reducing the financial risk arising from a mismatch of assets against liabilities. The new policy includes a target equity allocation of between 15% and 25% of total assets, down from a level above 40% last year. In practice, we are allocating newly trusteed assets into fixed-income strategies designed to closely track the performance of our liabilities. When completed, this reallocation will leave the PBGC with an overall asset mix of roughly 75% fixed income and 25% equity. Additional assets from newly terminated plans will be allocated to fixed-income strategies.*

PBGC Financial Summary

We have also included the 10-year financial summary for both PBGC's single-employer pension plans in Exhibit 13 and PBGC's multiemployer plans in Exhibit 14.

Exhibit 13: Financial Summary for Single-Employer Plans, 1995–2004

US$ in millions

	Fiscal Year Ended September 30,									
Summary of Operations:	**2004**	2003	2002	2001	2000	1999	1998	1997	1996	1995
Premium income	**$1,458**	948	787	821	807	902	966	1,067	1,146	838
Other income	**$24**	28	28	23	5	3	10	19	26	18
Investment income (loss)	**$3,197**	3,349	170	(843)	2,392	728	2,118	2,687	915	1,956
Actuarial charges (credits)	**$1,787**	6,161	2,802	1,082	453	(602)	815	488	632	1,561
Losses (credits) from completed and probable terminations	**$14,707**	5,377	9,313	705	(80)	49	584	489	118	169
Administrative and inv estment expenses	**$288**	290	225	184	167	161	158	155	150	138
Other expenses	**($36)**	97	15	2	(2)	(1)	6	29	3	19
Net income (loss)	**($12,067)**	(7,600)	(11,370)	(1,972)	2,666	2,026	1,531	2,612	1,184	925
Summary of Financial Position:										
Cash and investments	**$36,254**	33,215	24,851	21,010	20,409	17,965	17,345	14,988	11,665	10,026
Total assets	**$38,993**	34,016	25,430	21,768	20,830	18,431	17,631	15,314	12,043	10,371
Present value of future benefits	**$60,836**	44,641	28,619	13,497	10,631	11,073	12,281	11,497	10,760	10,388
Net position	**($23,305)**	(11,238)	(3,638)	7,732	9,704	7,038	5,012	3,481	869	(315)
Insurance Activity:										
Benefits paid	**$3,006**	2,488	1,537	1,043	902	901	847	823	790	761
Participants receiving monthly benefits at end of year	**517,900**	458,800	344,310	268,090	226,080	214,160	208,450	204,800	198,600	181,000
Plans trusteed and pending trusteeship by PBGC	**3,469**	3,277	3,122	2,965	2,864	2,775	2,655	2,500	2,338	2,084

Note: Data is for Single-Employer Plans.

Source: Pension Benefit Guaranty Corporation, Performance and Accountability Report (2004).

Exhibit 14: Financial Summary for Multiemployer Plans, 1995–2004

US$ in millions

	Fiscal Year Ended September 30,									
Summary of Operations:	**2004**	2003	2002	2001	2000	1999	1998	1997	1996	1995
Premium income	**$27**	25	25	24	24	23	23	23	22	22
Other income	**$0**	0	0	0	0	0	0	0	1	0
Investment income (loss)	**$54**	37	118	95	70	(56)	133	68	12	83
Actuarial charges (credits)	**$1**	1	0	1	0	0	0	(1)	1	2
Losses (gains) from financial assistance	**$55**	480	101	269	26	109	34	(3)	102	108
Administrative and inv estment expenses	**$0**	0	0	0	0	0	0	0	0	0
Net income (loss)	**$25**	(419)	42	(151)	68	(142)	122	95	(68)	(5)
Summary of Financial Position:										
Cash and investments	**$1,057**	984	933	796	682	681	736	585	498	472
Total assets	**$1,070**	1,000	944	807	694	692	745	596	505	477
Present value of future benefits	**$3**	3	3	4	4	5	6	7	9	10
Nonrecoverable future financial assistance, present value	**$1,295**	1,250	775	679	414	479	389	361	365	268
Net position	**($236)**	(261)	158	116	267	199	341	219	124	192
Insurance Activity:										
Benefits paid	**$1**	1	1	1	1	1	1	1	2	2
Participants receiving monthly benefits from PBGC at end of year	**320**	390	460	510	620	730	850	1,000	1,100	1,300
Plans receiving financial assistance from PBGC	**27**	24	23	22	21	21	18	14	12	9

Note: Data is for Multiemployer Plans.

Source: Pension Benefit Guaranty Corporation, Performance and Accountability Report (2004).

Last question: Who do you like in the Super Bowl this year?

- *Our stochastic model says the Patriots, the deterministic model says the Steelers, and, if the weather is good, I say the Colts.*

Disclosure Appendix

Important Global Disclosures

David Zion, CFA, CPA & Bill Carcache, CPA each certify, with respect to the companies or securities that he or she analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

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Outperform: The stock's total return is expected to exceed the industry average* by at least 10-15% (or more, depending on perceived risk) over the next 12 months.

Neutral: The stock's total return is expected to be in line with the industry average* (range of ±10%) over the next 12 months.

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**The industry average refers to the average total return of the analyst's industry coverage universe (except with respect to Asia/Pacific, Latin America and Emerging Markets, where stock ratings are relative to the relevant country index, and CSFB HOLT Small and Mid-Cap Advisor stocks, where stock ratings are relative to the regional CSFB HOLT Small and Mid-Cap Advisor investment universe.*

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Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

*****_CSFB HOLT Small and Mid-Cap Advisor stocks do not have coverage universe weightings._

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Restricted	2%	

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

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