

# EVOLUTION of U.S.

## How Employers Use Their Retirement

*U.S. pension plans have evolved from their 19th-century beginnings. Current trends are influenced largely by the need for dynamic and effective retirement programs that add value to both businesses and employees.*

By Ramon A. Aggabao

**I**N 1875, the American Express Co. established the first formal employer-sponsored pension plan in the United States. Most of the plans established over the next 50 years, up until the Great Depression, were in the railroad, banking, and public utility fields.

During this period, the economy was robust. The labor supply was more than adequate to meet the economy's needs. Prosperity was at its peak, with the middle class buying into a new innovation called "credit," the "buy now, pay later" scheme. The basic flaw of the period, however, was that during this era, business owners profited more than their employees, a discrepancy that contributed to the collapse of the economy in 1929.

Pension plans at this time had minimal government supervision. Employers had no legal obligation to provide retirement benefits. When a plan was in place, the sponsor maintained the right to deny, reduce, or terminate benefits at its discretion. Employees didn't earn rights to any pension benefit.

Private pension plans were either the defined benefit (DB) or defined contribution (DC) type. They were universally regarded as gratuities from a grateful employer to its employees, in recognition of long and faithful service. Employers adopted pension plans as a means to increase employee productivity,

thus furthering production output and ultimately increasing profits. For many years, this worked well.

### The Great Depression (1929 to Early 1940s)

The Great Depression was the worst and longest economic collapse in the history of the modern industrial world. Sales declined rapidly as consumers were unable to pay the credit debt they'd accumulated. Production decreased, leading to a severe rise in unemployment. Displaced workers, reaching as high as 25 percent of the nation's work force, lost their homes and savings. Consumers lost confidence in the stock market. It was against this backdrop that the Social Security Act was signed into law on Aug. 14, 1935.

Although no data are available, one can conclude that the number of pension plans declined sharply during the Depression. In a time when businesses were concerned with keeping their heads above water, employers weren't focused on pension plans.

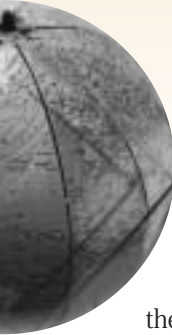
### Post-World War II (Late 1940s to 1974)

The involvement of the United States in World War II helped end the Great Depression. Industrial growth was stimulated, and unemployment was replaced by a shortage of workers. Opportunities for the American economy exceeded the resources available.



# PENSION PLANS

## Programs to Add Shareholder Value



American businesses placed a high priority on retaining employees for an entire career. Employers believed that with experience and with internal training and development programs, employees became more productive the longer they remained with the company.

Private pension plans helped employers attract and retain employees during this period in which labor demand exceeded supply. Plan sponsors had a paternalistic attitude toward long-term employees. From the worker's viewpoint, a pension plan was an assurance of lifetime security. After a 15-year period of depression, hardship, and war, Americans were more security conscious, and pension plans were welcome news. The desire for a secure retirement motivated employees to be loyal to their companies. For both employers and employees, having a pension plan was a win-win situation.

The number of pension plans increased dramatically from 1939 to 1974, as depicted in Chart 1.

Although pension plans proliferated after the war, there was still minimal government regulation. The only important re-

striction imposed on pension plans prohibited discrimination in favor of highly paid employees. The benefits employees earned still weren't protected. Plans typically promised benefits only to the extent funded. Plan sponsors could terminate a plan without assuming any liability for unpaid benefits.

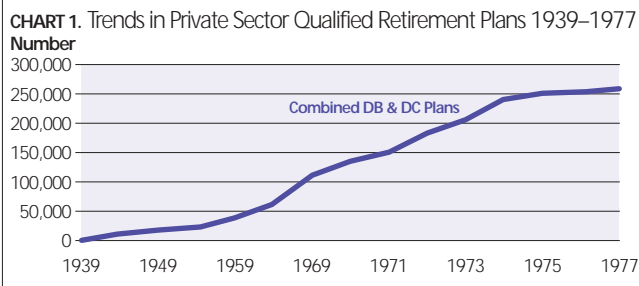
### Post-ERISA (1975 to 1979)

In 1963, the Studebaker automobile company closed its manufacturing operation in South Bend, Ind. Three years later it went out of business, leaving thousands of employees without pension benefits. The plight of the victims of Studebaker's demise prompted Congress to enact the Employee Retirement Income Security Act (ERISA) in September 1974.

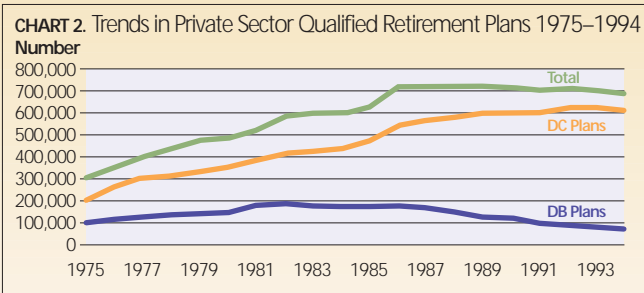
ERISA is the single most important legislation affecting qualified pension plans. Comprehensive and exceedingly complex, it covers all aspects of pension plan administration. It also created the Pension Benefit Guaranty Corp. (PBGC) to function as an insurer that guarantees payment of vested benefits in the event of termination of an underfunded plan.

Under ERISA, DB plans are more regulated than DC plans. Although there are latitude and flexibility in funding a DB plan, the Internal Revenue Service (IRS) set rules for calculating the minimum required and maximum allowed tax-deductible contributions for each plan year. Laws passed in the 1980s and the 1990s forced DB plans to accelerate funding even faster.

These new funding requirements have made DB plans costly, especially to small businesses of fewer than 100 employees. A significant number of small plan sponsors reacted to the requirements by switching from a DB plan to a DC plan, which has fixed, predictable annual contributions. This trend is presented in Chart 2, which shows a moderate increase in the num-



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ber of DB plans after ERISA was passed, reaching its peak in 1983 and then gradually declining after that. The decline is attributable to smaller companies that replaced their DB plans with 401(k) plans. These 401(k) plans are DC pension plans that allow employees to contribute “before-tax” dollars to their own individual accounts, with the employer having the option to match employee contributions.

### 1980 to the Present

Given the changed business environment of 1980, the pension system’s underlying objectives needed to be re-examined and re-defined. Employers had to change plan objectives to take into account new hiring policies brought about by current challenges. These challenges came from three fronts:

- *Baby boomers: the unavoidable demographics.* The baby boomer generation usually includes people born between 1945 and 1967. Before 1980, this group wasn’t a factor in the labor supply side of the economic equation. Since then, boomers have created an oversupply of young workers, and the size of the work force has caught up with the economic demand for human capital. With the exit of early boomers from the work force in the next 20 to 30 years, businesses are anticipating a shortage of workers, mostly in supervisory positions. Two solutions already being contemplated to alleviate the problem are job sharing and partial retirement.

- *Advent of advanced computer technology.* The progress of computer technology has been unprecedented over the past 20 years and undoubtedly will continue for years to come. Computer technology has had a large impact on businesses. On the positive side, it has made possible increased production without an accompanying increase in payroll and employee benefit expenses. However, computers and machines have cut drastically the numbers of factory and office workers. The once labor-intensive business environment is now knowledge-intensive, and a young, highly mobile work force is slowly replacing career-oriented employees.

- *Economic decline in the 1980s and the emergence of a global economy.* The American economy declined in the 1980s. This downturn resulted from changes caused by post-industrialization, the emergence of a global economy, and post-Cold War defense industry slowdowns.

A post-industrialization economy is based more on services and information processing than on manufacturing.

The associated loss of thousands of related jobs was tied closely to the development of a global economy. Major corporations continue to lay off thousands of employees in the 1990s in order to compete in the global economy.

### Current Trends: Birth of Hybrid Plans

With these new challenges reshaping the U.S. business environment, pension plan sponsors started to question the adequacy of traditional retirement vehicles and their ability to keep pace with the changing needs of employers and the work force. Specifically, they wanted answers to the following concerns:

- Is the recruitment and retention of career service workers still a relevant business objective, given the expected overflow of labor supply brought about by boomers?

- As the early boomers come close to retirement age, traditional DB plans, particularly final-average-pay plans, will become increasingly costly; fund liquidity will soon become a major concern. Are employers willing and able to divert available capital to support their pension plans?

- Would a traditional DB plan format be able to accommodate partial retirement?

- Does a pension benefit commencing in the distant future help the company attract young, talented workers?

- Business globalization has been accompanied by a new accounting standard in reporting pension costs. Publicly traded businesses are focused on profitability as a means to sustain and improve stock prices. Do traditional DB plans further this objective?

- Should businesses take full responsibility for providing adequate retirement security to their employees, or should employees start taking some of the responsibility for their own future?

After analyzing these concerns, more and more employers have concluded that a traditional DB plan format isn’t the right fit for their business needs. There’s no longer a pressing need to retain career service workers, since longevity is no longer the trend among the contemporary work force. Currently, only one in five employees remains with a single employer for the length of his career.

Under a traditional DB plan, it’s virtually impossible to provide partial pensions to semi-retired plan participants under the age of 65.

Assuming he’s able to understand the complex pension formula of a DB plan, a young worker may not put much value in a pension benefit that commences 30 years in the future.

Periodic pension costs are extremely volatile under a traditional DB plan, due to unpredictable investment returns and distorted demographics caused by boomers.

The American business system is no longer characterized by corporate paternalism. Even the largest companies now stress employee independence and an inter-reliance between employer and employee.

The lump-sum, individual-account aspect of DC plans offers some answers to these concerns. A pension plan that shows an increasing lump-sum benefit is more visible and attractive to young workers. Since benefits aren’t based on salaries at retirement, costs are predictable. A lump-sum benefit can be combined with other personal savings to give a worker a more accurate estimate of his total retirement savings.

However, sponsors of existing DB plans highlight the desirable attributes of a DB plan format, including funding and design flexibility, the anticipation of future forfeitures to reduce cost, and benefits from future investment gains. It must be point-



ed out that terminating a DB plan is costly and complex.

Employers have concluded that the ideal pension vehicle to address these concerns would be neither a traditional DB plan nor a traditional DC plan, but rather a “hybrid plan” that combines the best features of both. By simply reshaping a traditional DB plan into a hybrid plan, a DB plan need not be terminated.

The most popular of the hybrid plans is the cash balance (CB) plan.

#### Cash Balance Plans

Bank of America implemented the first CB plan in 1985. Since then, at least 500 companies have implemented similar plans. Most of the early CB plan sponsors were large companies. Today, 22 percent of *Fortune* 100 and at least 14 percent of *Fortune* 500 companies have CB plans. Among the large companies that have switched to CB plans are IBM, AT&T, Kodak, and Xerox. Many others, including medium-sized companies, are currently designing or exploring CB or other hybrid plan designs for their employees.

A CB plan resembles a DC plan in that it involves a hypothetical account balance for each participant. Every year, a participant earns a “contribution.” A “pay-related” credit and an “interest-related” credit, the two key components of a CB plan, are added to his account. The account represents the present value of the underlying accrued pension benefit.

The rate used for the interest-related credit may vary from year to year. Typically, it's based on an external, objective index such as the yield on U.S. Treasury bills. The pay-related credit is a percentage of monthly pay. This may be a fixed percentage, or increase with age, service, or both.

The differences between CB plans and DC plans are:

- In a CB plan, there's neither an actual setup of individual accounts with the plan's trustee nor an actual allocation of funds to each account. These are virtual “bookkeeping” devices to keep track of the accumulated balances.
- CB plans have no employer matching contribution.
- A CB plan is totally financed by the employer.
- The interest-related credit of a CB plan isn't tied to the actual investment performance of the fund. The fund may earn more or earn less than the total interest credited to the accounts. The sponsor takes all the investment risk while the participants earn a guaranteed rate.

- As in a DB plan, the normal form of benefit payment is an annuity, with lump-sum distribution an option. The lump-sum balance is converted to an annuity using an interest rate and a mortality table prescribed in the plan document.
- Withdrawals from a CB plan aren't permitted during employment.

#### Merits of Cash Balance Plans

- CB plans can save traditional DB plan sponsors money.
- A CB plan is more visible to employees. Employee appreciation is reinforced through periodic account statements.
- CB account balances can never go down, whereas DC accounts invested in stocks may lose part or all of the principal. The lump-sum balance at any time becomes the employee's minimum benefit.
- Vested benefits are guaranteed by PBGC.
- Employees are usually given several alternative forms of benefit payment, including lump-sum, straight life annuity, certain and life annuity, or joint and survivor annuity.
- CB plans can accommodate the part-time employment of retirees. Upon retirement, the full account balance is payable to the participant if he so elects. Upon rehire, he may continue accruing benefits again if he works at least the minimum number of hours as stated in the plan.

#### Issues Concerning Cash Balance Plans

CB plans are now under close scrutiny from the Department of Labor, the IRS, and the Securities and Exchange Commission (SEC). The SEC ruled that a conversion from a traditional DB plan to a CB plan must be included in the agenda of a stockholders' meeting.

What are the complaints raised by opponents of CB plans? The basic issue involves a core difference between DB and DC plans—DC plans favor younger employees, while DB plans provide the greatest benefit to older employees with long service. As the benefit accrual pattern of a CB plan resembles that of a DC plan, opponents claim that converting a traditional DB plan to a CB plan is age discriminatory.

In most conversions, however, the new CB plan contains a grandfather clause, in which employees close to retirement, usually those over age 55, get the bigger of the old plan benefit and the CB plan annuity equivalent.

In 2000, a federal court ruled that CB plans don't violate federal prohibitions on age discrimination.

#### In Conclusion

The current economic situation has created large funding deficiencies for most defined benefit plans and has depleted a significant percent of retirement savings for 401(k) participants. As plan sponsors scramble to find the right balance between survival and providing for employee economic security, employers will continue to use their retirement programs as strategic tools to add value to their businesses and their employees. ●

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