

# DEFINED COST



# New Hope for Defi

## Though participants in a DCPD would bear the risk of disappointing investment performance, investment return and mortality risks would be “pooled” among all plan participants.

By Kenneth A. Steiner

**D**efined benefit plans may not be dead, but they’ve been declining, and the decline has been steady and steep. Of those defined benefit plan sponsors still standing, many are considering terminating or freezing their plans, and either expanding their existing defined contribution plans or adopting new ones.

Defined contribution plans have their place and offer some significant advantages, but they can’t match defined benefit plans in providing dependable, lifetime retirement income. The time may be ripe for a new type of retirement plan—the *defined cost* pension plan (DCPP).

Under this type of plan, the sponsor’s contribution would be discretionary, like contributions to a defined contribution profit sharing plan, but the benefits would be determined based on a plan formula, like a defined benefit plan. These plans could provide the best of both the defined contribution and defined benefit worlds—significantly reducing liabilities for plan sponsors while providing reasonably dependable lifetime income to plan participants.

### Retirement Plans: The Basics

There are two basic types of retirement plans in the United States today. Defined contribution plans provide participants with individual accounts. According to Sec. 414(i) of the Internal Revenue Code (IRC), the benefits payable under these plans depend “solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.”

The best known and most common type of defined contribution plan is probably the 401(k). The plan sponsor’s obligation under the 401(k) plan is generally limited

to making contributions. Plan participants are responsible for making sure the plan generates enough income to meet their needs after they retire.

In a defined contribution plan, there are no promises and no guarantees (and thus no premiums to pay to the Pension Benefit Guaranty Corp. [PBGC]). Accounting rules for defined contribution plans are quite simple. For most defined contribution plans, their annual expense is the amount the sponsor must contribute to the plan for the year.

A defined benefit plan is “any plan that is not a defined contribution plan,” according to Sec. 414(j) of the IRC. Generally, retirement benefits payable under defined benefit plans are spelled out in a plan document, often by a formula involving the participant’s years of service and compensation. Once a participant earns a benefit under the plan’s terms, it may not be reduced.

Plan assets used to pay benefits are not allocated to individual plan participants but rather to a plan trust, where they are invested by the plan’s fiduciaries. Typically, defined benefit plan sponsors must satisfy complicated minimum funding requirements imposed by law to fund the benefits payable under the plan. Since plan benefits are guaranteed by the PBGC, plan sponsors must also pay premiums to the PBGC for that coverage. If a plan sponsor terminates a defined benefit plan with insufficient assets, the sponsor is liable for any funding shortfall. If the sponsor cannot meet this obligation, the PBGC pays the unfunded benefits, up to certain limits.

Thus, plan sponsors bear most of the risk and responsibility for ensuring that promised benefits will be paid. In keeping with the greater legal obligation, accounting rules for defined benefit plans are much more complex than those for defined contribution plans. Annual plan

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accounting expense may fluctuate significantly from year to year, and sponsors of underfunded plans may be subject to reductions in shareholder equity.

### **Declining Market Share**

In 1984, there were 2.6 single-employer-sponsored defined contribution plans for each defined benefit plan, according to U.S. Department of Labor statistics. Today, that ratio is now estimated to be at least 15 to one. Surveys by actuarial consulting firms and others indicate that freezes or terminations of defined benefit plans have increased significantly in recent years, mostly in response to poor investment performance and low interest rates.

The declining popularity of defined benefit plans over the past 20 years has largely resulted from the increased popularity of defined contribution plans. In the booming 1990s stock market, many investors came to expect 15 percent to 20 percent annual investment returns. The security offered by defined benefit plans paled next to the wealth potential of 401(k)s, and workers pushed employers to expand contributions to defined contribution plans or to adopt new plans. At the same time, the government was enacting more regulations governing defined benefit plans. Many plan sponsors were quite willing to heed the call for more defined contribution benefits. When the stock market bubble burst in 2000-2002, employees yearned for their old defined benefit plans, but by that time employers were reluctant to restore them.

Support among sponsors for traditional defined benefit plans appears to be waning at the same time that the recent market slump has exposed the weaknesses of defined contribution plans. That's not a coincidence. As employees have become painfully aware of the financial risks of receiving contributions today versus promises of lifetime income after retirement, sponsors have discovered that it's easier for them that way. Adopting defined contribution plans enables plan sponsors to bypass the risk of market declines and the burdens of the more complex accounting rules and additional government regulations that come with defined benefit plan sponsorship.

To protect both defined benefit plan participants and the PBGC, the Bush administration and some members of Congress are considering changing pension funding rules to require accelerated funding for underfunded defined benefit plans. These changes may increase funding volatility and put more financial pressure on plan sponsors. Further, the pursuit of "transparency" is leading the accounting profession toward some form of "mark-to-market" accounting for defined benefit plans that will certainly increase volatility for expense reporting. The administration is also pushing for significant expansion of individual savings plans that will most likely have the effect of discouraging employer-sponsored retirement plans in general.

Finally, pension rights advocates and many in Congress appear to believe that in addition to preserving benefits accrued to date, defined benefit pension law also should protect participants' expectations of future benefit accruals—a completely unacceptable proposition from a plan sponsor's perspective.

Current political, economic, and regulatory trends have all conspired to diminish enthusiasm for defined benefit plan

sponsorship at a time when workers rue the much lower balances on their defined contribution plan statements (sometimes now referred to as 201(k) statements) and glumly postpone their plans for retirement.

### **Defined Contribution Plans: The Cons**

The basic problem with defined contribution plans is that a retiree's retirement benefit depends on the size of his or her account balance. Thus, lifetime retirement income may be adversely affected by poor investment choices, early withdrawals, or inadequate contributions before retirement.

After retirement, the participant still must manage the investments wisely, in addition to figuring out how to ensure the account balance lasts a lifetime. Workers covered only by defined contribution plans risk either spending too much—and outliving their account balance—or spending too little—which may be good news for heirs but impose unnecessary self-denial on retirees. And since investments often fluctuate from year to year, it may be difficult to maintain a stable standard of living from investment income alone.

In defined benefit plans, the risks inherent in investing and predicting longevity are pooled. Not so in defined contribution plans. Thus, some defined contribution plan participants may flourish while others struggle, depending on how long they live and how the market performs. Since many of today's retirees have defined benefit plans, we have yet to fully experience the significance of the shift from defined benefit to defined contribution plans, which may profoundly affect the financial security of future generations of retirees.

### **Social Security to the Rescue? Not Likely.**

Social Security is a defined benefit-type program with tax rates set by law. Social Security trustees acknowledge that the program is out of balance, with estimated future income less than estimated future payouts over the 75-year long-range projection period. Solutions to Social Security's financing problems include raising taxes, reducing benefits, or some combination of the two.

Some critics of the current program have suggested establishing individual accounts for participants, but this would not eliminate the need to raise taxes or lower benefits, in the short term at least. Given its current underfunded position and the push for individual accounts, it seems unlikely that Social Security will be expanded anytime soon to provide greater dependable lifetime benefits.

### **Solution: Defined Cost Pension Plans**

It might be possible to rekindle the flame under traditional defined benefit plans, but it would require significant changes from employees, plan sponsors, and regulators. It may also require additional incentives, such as taxing the benefits at favorable rates.

A more pragmatic solution—one with appeal for all parties at the table—is the defined cost pension plan. DCPPs could be a win-win solution to our current retirement woes.

Under a DCPP, the plan sponsor would determine the amount of the annual contribution it would make to the plan, but no individual participant accounts would be established. Instead, benefits under the plan would be determined by a formula.

## Something needs to be done about today's relentless decline in traditional defined benefit plans and the prospect of future retirees struggling to keep their 401(k)s alive as long as they are.

Since DCPPs would not establish individual participant accounts, they would technically be considered defined benefit plans under current law. However, the DCPP would actually be a hybrid, incorporating both defined benefit and defined contribution features. Many of the current rules that apply to qualified defined benefit plans also would apply to DCPPs.

A DCPP would be a tax-qualified retirement plan directed by a plan administrator. The plan administrator would be subject to current law fiduciary requirements, and would invest plan assets and determine the plan's benefit formula. Unlike traditional defined benefit plans, however, DCPPs could reduce accrued benefits if the plan administrator, with the assistance of the plan actuary, determined that the plan had become underfunded. Thus, adopting a DCPP would require a change to current pension law.

Employee contributions would be permitted in DCPPs on a tax-deferred basis. Sponsor contributions could vary from year to year, based on corporate profitability. There would be no PBGC protection or minimum funding requirements, and annual accounting expense would equal contributions.

Since there would be no guaranteed benefits, the plan administrator would also be charged with taking prudent actions designed to minimize the likelihood of having to reduce accrued benefits. To protect benefits accrued under a DCPP, the government could enact "accrued benefit preservation" requirements, such as:

- The plan administrator, with the assistance of an enrolled actuary, would annually inform the plan sponsor of the contribution required to purchase that year's benefit accrual. If the plan sponsor failed to make this contribution, the benefit accrual for the year would be reduced proportionately. Thus, if an employer didn't make any contribution for the year, there would be no additional benefit accrual for that year. This requirement would be designed to prevent diminution of the plan's funded status through additional plan accruals.

- There would be at least three priority categories of accrued benefits. The first priority would be benefits attributable to employee contributions. The second priority would be benefits in pay status or benefits that could have been in pay status for some period of time (but ignoring any increases in benefits adopted in the recent past). All other benefits would fall into the third category. If the plan administrator and enrolled actuary determined that there weren't enough assets to fund accrued benefits, Category 3 benefits would be reduced in proportion to the present value of benefits accrued. If plan assets could not cover Category 2 benefits, those benefits would have to be reduced as well. The same rules would apply in the event of a plan termination with insufficient assets.

- Benefits would be paid in the form of a life annuity or other life annuity-type option. There would be no lump sum options. Alternatively, lump sums would be payable only if plan assets covered estimated plan termination liabilities, or partial lump

sums could be payable up to the amount of assets that would be allocated to the participant in a plan termination.

- Excess assets could not revert to the plan sponsor. They would have to be used to increase accrued benefits on plan termination.

- Plan mergers would be prohibited unless the plans involved had approximately the same funded status on a plan termination basis. Participants who are spun off to their own plan as part of a transfer of assets and liabilities must receive the same percentage of plan assets as they would have received if the original plan were terminated on the day before the spinoff.

Because formula benefits wouldn't be guaranteed, plan participants would be entitled to receive detailed, regular communication on the plan's funded status. Annual statements would provide the participant's accrued benefit, the plan's investment experience, investment strategy, market value of assets, approximate plan termination liability, and the approximate benefit to the participant if the plan were to terminate on the statement date.

Companies could still sponsor more than one type of plan, and DCPPs could coexist with defined contribution plans and traditional defined benefit plans. As under current law, there would be limits on sponsor deductions to fund these plans, although the limits would be increased to permit reasonably adequate funding of DCPP benefits.

### Summing Up

Similar to a defined contribution plan, participants in a DCPP would bear the risk of disappointing investment performance—but they would receive the rewards for superior results as well (via higher benefits determined by the plan administrator). But in a DCPP, investment return and mortality risks would be "pooled" among all plan participants, thus reducing risks considerably for individual participants. Also, DCPP "accrued benefit preservation" provisions would be designed to provide protection for the benefits accrued under the plan.

Plan sponsors would win under this approach, because they would no longer be subject to significant financial risks. Participants would win because their investment and mortality risks would be pooled, resulting in more predictable and stable retirement income than under defined contribution plans. And the country would benefit because more retirees with dependable lifetime retirement income would reduce dependency on Social Security and other government programs.

Something needs to be done about today's relentless decline in traditional defined benefit plans and the prospect of future retirees struggling to keep their 401(k)s alive as long as they are. DCPPs could be a solution everyone can live with. ●

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