

The Truth About Defined Benefit Plans

RECENTLY, MUCH HAS BEEN WRITTEN regarding the demise of the traditional employer-sponsored defined benefit plan. The signing of the Pension Protection Act of 2006 (PPA) into law has been heralded by some as the advent of legislation that could possibly save defined benefit plans. In actuality, it may have just the opposite effect. The PPA will positively affect pension security under some existing defined benefit plans. It will also, however, encourage or require many employers that currently sponsor defined benefit plans to either terminate or freeze the accrual of future benefits. The message the PPA delivers to employers that maintain defined benefit plans is: Be prepared to fund plans responsibly, or incur negative consequences. On the surface, this message makes sense, but it certainly won't help to encourage employers to sponsor these plans.

increase the acceleration of conversions of some traditional defined benefit plans to cash balance plans.

So despite the PPA, traditional defined benefit plans will continue to terminate at a rapid rate. Why? Because, at the risk of oversimplification, they're not in the best financial interest of employers. Employers ultimately decide on the type of retirement program to provide their employees. When employers consider the potential financial impact of a defined benefit plan, it's abundantly clear that defined contribution plans are the better choice.

Though the vast majority of defined benefit plan terminations have occurred in the private sector, it now appears that this trend will be spreading to the nonprofit and public sectors as well. Many non-private employers have looked into eliminating their defined benefit plans for future employees or substituting a defined contribution plan in lieu of future defined benefit plan accruals.

The unions representing state and municipal workers have been successful in keeping many defined benefit plans intact. As the cost of these plans increases, however, requiring higher taxes, their continuation will become more difficult to justify. Many nonprofits have looked into changing their defined benefit plans in response to pressure from their larger financial supporters as a way to reduce administrative overhead. Even though defined benefit plan terminations in the public and nonprofit sectors haven't been as rapid as with private employers, very few new plans have been established of late.

The single greatest risk that exists under any type of pre-funded retirement plan is the trust investment experience. Under a defined benefit plan, this risk is fully assumed by the employer that funds the plan. It's the employer's financial responsibility to provide sufficient funds to the plan trust to cover the promised benefits. Consequently, poor investment performance will necessitate additional contributions. This

In essence, the PPA has no meaningful provisions that encourage the creation of new traditional defined benefit plans. There are provisions for the creation of "defined benefit/401(k) plans" and additional stipulations that help clarify the legitimacy of cash balance plans. But the proposed defined benefit/401(k) plans will be available only to smaller employers and are actually two separate plans packaged together. Though the provisions covering cash balance were welcomed legislation, they'll probably only

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will divert funds that could have been available for research and development or other business needs.

Under new accounting rules, any shortfall between the fair value of plan investments and the plan's projected benefit obligations will have to be included on the financial statement balance sheet. The projected benefit obligation is actuarial present value of the benefits determined, based on past employment service but reflecting future compensation increases for pay-related benefit formulas. The effects of this inclusion on the balance sheet could affect a business's ability to borrow funds at competitive rates or negatively affect a public company's stock price.

The overall administrative expenses of maintaining a defined benefit plan are generally much higher than under a defined contribution plan and must be incurred by the employer. This isn't the case under a defined contribution plan, where employee accounts can be charged with reasonable administrative fees. Under a defined benefit plan, there are actuarial fees, accounting fees, investment management fees, legal fees, and PBGC premiums. PBGC premiums can be extraordinarily high for a plan that is underfunded.

In addition, should an employer elect to or be required to terminate an underfunded defined benefit plan, more PBGC fees are incurred. The PBGC may also bring a claim against the employer's assets (including related businesses) to recoup any liabilities the PBGC will be exposed to as a result of guaranteeing a terminated plan's benefits.

When considering these negative attributes of defined benefit plans, it's only logical that employers would prefer to have their employees covered by a defined contribution plan. Defined contribution plans shift the investment exposure to the plan participant, thus eliminating issues of underfunding. There are no actuarial fees or PBGC costs to be incurred, other reasonable administrative costs can be paid by the participant accounts, and issues regarding the effects on corporate financial statements don't apply.

This brings us to two questions to consider: First, is the traditional defined benefit

plan worth saving? And if the answer to that question is yes, then what would be needed to restore its popularity?

By and large, the American public supports the guaranteed lifetime income that traditional defined benefit plans provide. This statement is based on the public's negative reaction to the President Bush's suggestion that personal accounts become part of our Social Security program. It appears that the majority of our citizens are not eager to assume the investment and longevity risks associated with personal accounts (defined contribution benefits).

On the other hand, many employees no longer express strong dissatisfaction with their employers when they terminate a traditional defined benefit plan. This wasn't the case 10 or 15 years ago when employers first started abandoning these plans. This can be attributed to a combination of factors.

One factor is that it has become so commonplace for employers to terminate these plans, employees are no longer shocked by such action. Another factor is that employees are starting to understand the financial strain these plans place on their employers. The significant change in the working patterns of employees over the past several decades has also contributed to a more tempered response to defined benefit plan terminations. The career employee has become rare, with most individuals working for many different companies over their working lifetimes. The inherent portability offered by defined contribution plans makes them more suitable for a mobile workforce.

One might argue that it's not so much the traditional defined benefit plan that's attractive to employees but the guarantee of lifetime retirement income without investment or longevity risk. If this guaranteed income could be provided through defined contribution programs, then the value of the traditional defined benefit plan may be significantly reduced. It appears, however, that even though employees have the option to have their defined contribution account balances converted to a guaranteed annuity purchased from an insurance company, they seldom opt to do so. (The reasons for this are beyond the scope of this short article.) Consequently, the traditional defined

benefit plan remains the best mechanism to deliver guaranteed lifetime annuity income. So assuming it's worthwhile to preserve the current systems and encourage establishment of new defined benefit plans, what might be done?

Ultimately, it would be up to the federal government to take drastic action and provide new legislation. This, of course, would occur only if strong interest was demonstrated by employers, employees, and other interested parties.

One change that might encourage the establishment of defined benefit plans would be to allow for tax-deductible employee contributions. Clearly, the trend is to have employees fund part of their retirement benefits, as is demonstrated by the popularity of 401(k) plans.

Another idea might be to allow benefits to be adjusted based on plan investment experience, mitigating the risks associated with negative investment experience. This, however, should be subject to certain restrictions on how plan assets are being invested. A provision granting more favorable tax rates on annuity distributions under defined benefit plans would certainly make them more attractive to employees.

Finally, an option to waive PBGC coverage should be available for plans satisfying certain requirements. Such requirements might include a commitment to maintain a minimum asset-to-liability level, use of certain asset categories, and coverage under some form of federally approved private insurance.

Many of us professionals in the retirement consulting field are very supportive of defined benefit plans and the security they offer to those being covered under them. Nevertheless, those of us who serve our clients in the retirement plan area need to be realistic about their future prospects if these plans have any chance of surviving in their current or in some related form. ●

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