

The Future of Defined Benefit (DB) Plans

(Author's Note: This is the opening keynote speech delivered by Ron Gebhardtsbauer on Dec. 6, 2006, at the national Plan Sponsor conference in Washington, DC on "The Future of DB Plans." Gebhardtsbauer is the senior pension fellow at the American Academy of Actuaries. The views expressed here are his own and do not necessarily reflect those of the Academy.)

Good Afternoon! I would like to thank Plan Sponsor for inviting me to speak on "The Future of DB plans." This is an incredibly important topic for employers, employees, and the nation. While the delivery vehicle may be evolving, and thus DB plans may look different in the future, the essential need for retirement security, for a guaranteed *lifetime* income, remains critically important.

This topic may be even more important than some realize. The recent elections pointed out that, despite improvements in the economy, voters still felt economically insecure. Maybe it was, in part, because it seems like every week there were reports of another large employer freezing its DB plan. Political analysts suggested that voters' feelings of insecurity nullified the "good economy" advantage of the incumbent party and may have contributed to the climate for change in Congress.

There has been a decline in DB plans. So, let's step back and look at what has been happening to DB plans. You probably have seen the statistics from the Department of Labor, which show a decline in DB plan coverage from 40 percent to 20 percent of the private work force. And, that information is old. Now, it is less than 20 percent, due to recent freezes, which are the understandable result of a number of things, including: (1) the perfect storm that focused us on volatility, (2) only *temporary* fixes to the funding rules for four years, and (3) the lack of clarity in the law for cash balance plans. These three issues hurt the reputation of DB plans among top management. So, it has been a difficult and depressing six years for advocates of retirement security.

It's a new day now. We've turned the corner on the three problems I just cited:

- (1) The perfect storm is in the past. While some newspapers are still quoting the \$450 billion underfunding number, the real story is the opposite. The underfunding in the S&P 500 pension plans is under \$50 billion on an accumulated benefit obligation (ABO) basis, and their average funding ratio is back over 100 percent.
- (2) The *temporary* fixes to the funding rules are history. As you all know, Congress finally passed the Pension Protection Act of 2006 (PPA), which includes a *permanent* fix to the funding rules. And, guess what? They are not so bad.
- (3) PPA clarified the legality of cash balance plans going forward, and the Seventh Circuit determined that the IBM cash balance plan was not age discriminatory. The retroactive issue is still being litigated elsewhere, so let's hope the Second Circuit and others agree.

So, I am smiling more these days. The law is clearer now, and the funding rules are not as bad as some initially said they would be.

How can I say the new funding rules are not so bad? Aren't they *more volatile*? I don't think so, and the actuaries at Towers Perrin agreed in a recent paper on PPA. For example:

- (1) In the past, if a plan's funding level dropped below 80 percent, contributions could easily double under the so-called deficit reduction contribution (DRC) rules. Many employers wanted those rules changed, and they were. The new at-risk rules under PPA still increase contributions if the funding level drops below 80 percent, but they gradually increase the contribution over five years, which is a much more sensible rule.
- (2) Plan sponsors can contribute more to the pension plan under PPA. This will provide the flexibility to put more money in during good times so that plans can get through the difficult times with more ease.
- (3) PPA makes it easier for plan sponsors to hedge market risk. Under the old DRC rules we have to smooth the bond rates, but under PPA we can elect to use current bond rates. We don't have to use two-year smoothing.¹

DB plans are not out of the woods yet. Accounting rule changes going into effect at the end of this year put pension and retiree health plans right on the company balance sheet. So, what is the effect of these new rules? They will reduce, at least initially, the net worth at many companies that have DB plans. This can happen even if their DB plans are over 100 percent funded, because the old accounting rules built up an artificial asset on their balance sheet that will be eliminated now. In fact, eliminating this artificial asset could wipe out the net worth of a few large companies, which could unnerve their investors.

On the other hand, many market analysts and bond rating agencies say this won't change their analysis, because they already know about the problems with the accounting rules. All the market information is already in the footnotes, and they have been using it for years. Nevertheless, it will be interesting to see what happens when the financial statements come out early next year. Will stock prices fall for some companies? Maybe not — knowledgeable investors know this change is going to happen, and stock prices are still increasing today, so it may be a non-event. Companies, however, should probably change the language in their loan covenants and the calculation of employee bonuses (if they haven't done it already). Could the new rules change anything else? Will they cause sponsors to drop their DB plans to keep their net worth from being volatile? A Credit Suisse (CSFB) report showed that the new rules could actually reduce volatility at many companies. The report didn't mention this, but a reduction in volatility could also be due to the old rule requiring a hit to equity under the minimum liability rules whenever there is an unfunded ABO, and the pension

¹ The Academy's Pension Committee suggested to Congress that the funding rules could smooth the contribution, not the assets and liabilities, but this was too new an idea to be included in the bill. We need to discuss it more so that it would be more acceptable the next time pension funding is addressed.

funded status sometimes going in the opposite direction from the retiree medical funded status.

Another accounting change is on the horizon. Phase II of the accounting changes will affect the *income* statement several years from now. The result is that companies with DB plans may see their *earnings* become more volatile, unless they reduce their equity exposure. However, the accounting changes may put the volatile pieces in a separate bucket, so earnings may not be as volatile as feared. In addition, the analysts and bond rating agencies know everything they need to know from the current footnotes and have already been cranking the information into their calculations. So, again the question — if there is no new information, will it affect stock prices or a company's ability to borrow? We don't know yet. On one hand, we might cite that many UK companies closed their DB plans to new employees after similar accounting rule changes were implemented in their country, but it may have occurred for other reasons. In addition, some UK companies resolved their concerns by moving to bonds and managing their volatility better. Of course, moving to bonds increases the employer's expected pension contributions, so many employers may prefer to switch over to 401(k)s and let the employees take on the risk. In the late 1990s, employees seemed to want that, but I'm not sure what employees want today.

Thus, I think the funding and accounting changes will *not* mean the end of DB plans. A bad image does hurt, however, so a change in the perception of top management is important.

I think the real influencer may be whether prospective employees want a DB plan and whether the DB plan still makes sense for employers to maintain their workforce. An article in the *New York Times* on 11/26/06 stated that private sector workers should not envy the good pensions of their public sector counterparts. Instead, it said they should go to their employers and fight to retain their DB pension plans. Actually, more than two-thirds of the S&P 500 still have a DB plan. Traditional DB plans can still make sense, particularly for union and government sponsors, because their workforces are not as mobile. According to a survey of plan sponsors by SEI, over 70 percent of union plans will remain DB. Government employees also like the DB promise — for example, when given a chance to switch, less than 5 percent of Florida's government workers chose to leave their DB plan for a defined contribution (DC) plan. Union and government employees still fight for DB benefits, so why don't the white-collar employees in the private sector?

Maybe it is because cash balance plans, which can make more sense for mobile employees, have gotten a bad reputation. That attitude is changing due to the IBM decision and the language in PPA. In fact, two major unions have expressed interest in cash balance plans. Many small- and medium-size employers have started cash balance plans recently. If smaller employers with cash balance plans can attract new employees, then large employers should find similar success. Certainly, large employers no longer want the early retirement subsidies in traditional DB plans. Inflexible early retirement provisions don't make sense for employers anymore because

they push employees out the door at too young an age, even when employers need a larger workforce. They don't make sense for employees either, because new employees don't know whether they will be able to stay with their employer long enough to get early retirement. So, maybe cash balance plans will pick up again. Indexed pay DB plans with formulas like Social Security should also be explored, since they are very similar to cash balance plans. While employers are concerned about the inflation risk, there may be ways to modify that to make them more acceptable to employers. For example, pay could be indexed up to retirement age at the average annual bond rate — 1 percent (i.e., an investment-related rate that approximates average salary increases over time).

I'm sure we'll still read about additional large employers freezing their DB plans and switching to 401(k)s. An interesting point is large employers that recently made the switch are learning that freezing their DB plan was not a panacea, especially if they invested in equities. Freezing a DB plan can force a sponsor to sell all its equities and move to 100 percent bonds, because there is little advantage to hold stocks in a frozen plan. Any surplus at termination will be subject to the confiscatory reversion tax (on top of the 35 percent income tax).

In addition, sponsors switching to 401(k)s will find that their employees are making many mistakes at each decision point. Employers won't find it easy to retire with dignity their employees who didn't contribute, which could be 30 percent unless they make deductions automatic. Sponsors also will find that their 401(k)s are not good at helping the employer maintain the workforce. They risk the mass retirement of their older employees when the stock market does well, which is typically when a company wants to retain employees. And, when the stock market is down, there may not be enough work. Employees, however, won't want to retire because they won't have enough money, so employers will have to lay off employees.

Fortunately, PPA has some good provisions for 401(k)s, such as the automatic provisions for enrollment, larger contributions, and life-cycle investments. These rules are particularly important for workers who don't have a DB plan, but they still don't mimic all the advantages in a DB plan. For example, I don't know if it will ever be possible to get employees to buy annuities with their 401(k) balances, so there will be many retirees running out of money in their 80s.

Thus, we will still find that having both DB and DC elements is essential for both employers and employees. New types of hybrid plans that combine both elements, through the new DB-K rules, may also lead to interesting ideas that we haven't thought about yet. For example, employees today don't know how long their 401(k) money will last in retirement, and there is a risk that 20 years from now many retirees in their 80s will run out of money. A DB-K type plan that has both 401(k) and DB elements could solve this problem by including a guaranteed lifetime pension starting at age 80. With this type of hybrid plan, a retiree would have a better chance at making sure their 401(k) money lasts until they are age 80, at which time the pension would begin. The DB portion could become the longevity insurance it was originally meant to be. The plan also could include the purchase of long-term care insurance at group rates. Ideas like

these are floating around Capitol Hill, because there needs to be some flexibility in the law to accommodate these ideas.

There are other fixes in pension law that still need to be made. For example, PPA didn't fix a major problem. As I noted earlier, PPA allows employers to contribute more in good years, but employers say they won't put any more money into the plan than required, because of the reversion tax. PPA could have fixed this problem by allowing pension surpluses to be used for other employee benefits, such as the employee health plan. The UAW testified for it, and the AFL-CIO and employers also were supportive. Even employee advocates figured out a way to address the issue with a side fund that collected contributions in excess of the minimum. However, the idea didn't get into PPA. This is one of the most important fixes needed to make DB plans viable.

There is another important fix for our tax laws. Taxes heavily influence our decisions, particularly an employer's decision to provide a retirement plan. Whether you are a fan of DB or DC plans, or both, this is important. When Congress reduced the capital gains and dividend tax rates to 15 percent, it removed over half of the tax advantages of retirement plans (DB and DC) that went to decision makers. These tax advantages compensated employers for sponsoring a retirement plan, jumping through all the regulatory hoops, and subjecting themselves to much litigation. Equilibrium is established when each employer decides if the tax advantage is enough for them to sponsor a plan. If the tax advantage is reduced, then some employers will rethink their decision to sponsor the plan. The 15 percent tax rate goes back up in a few years. If Congress considers reducing it again, they should consider giving that same tax rate to DB and DC distributions also since they compete for the same money. In fact, the law could encourage lifetime security by only giving the tax break to lifetime incomes, not lump sums. If the government gives this additional tax break, then there would have to be a good reason. And, there is — it would help the country avoid having many older retirees run out of money 20 years from now.

Finally, one last idea to consider is encouraging top management to care about the employee plan more. PPA took a step in this direction by prohibiting the funding of the non-qualified plan, if the employee plan was poorly funded. Unfortunately, this PPA provision could have an unintended consequence. It could encourage the employer to terminate the DB plan to avoid the funding restriction. A solution would be to require the non-qualified plan for top management to mirror or mimic the employee plan. If the employees don't have a pension plan, then neither does top management. If employees get a 401(k) plan, then that is what top management would have. If the employees get an inexpensive DB plan, then that's what top management would get. This suggestion might get top management to appreciate what they provide employees again.

In summary, I want to go back to the original concern of this session. Are DB plans going to die, or are they going to come back? I challenge this conference not to fall into the trap of saying that DB plans are on their way out due to the funding and accounting rules. They can survive those changes. Instead of looking back and projecting a disheartening trend, let's discuss what elements in DB plans are valuable and won't

easily be obtained elsewhere, such as the flexibility, the guarantees, and the pooling elements. These are items that are valuable not only for employees, but also for employers and the government. Thank you for this opportunity to make the case for a retirement policy that includes both DC and DB elements. Thank you.