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The Case for Defined Benefit Pension Plans

Defined Benefit (DB) pension plans have become unfashionable. Concerns about the unpredictability of cost for DB pension plans have led corporations to terminate or freeze existing DB plans and replace them with Defined Contribution (DC) plans. This trend is already far advanced in the United States, with other countries following rapidly in their wake. DB and DC plans are intended to provide income security to the retirees. How well they succeed must be judged in the context of the risk to the income security they are meant to protect. The recent economic meltdown is a good time to reevaluate which type of plan makes most sense going forward.

The trend to DC plans has brought decidedly mixed blessings to employees:

- It is true that DC plans provide transparent and portable benefits, while giving participants some control over the investment of their personal fund. The existence of investment choice, however, does not shield the participant from investment risk. The conventional advice is that participants should invest in equities when young and switch to bonds on nearing retirement. Although this strategy does reduce some of the risk, it cannot change the fact that the benefit provided by a DC plan depends heavily on investment returns over the participant's period of employment. Long-term market downturns after retirement or for participants near retirement can be devastating. On the other hand, DB plans provide a steady retirement income, with no investment risk.

- Advocates of defined contribution plans point out that each employee has the ability to tailor the investment portfolio to his or her individual needs and financial situation, including the choice of how much to contribute, if anything at all. However, these apparent advantages could also hinder the vast majority of workers who do not possess the financial savvy to choose the correct investment vehicles or have the discipline to voluntarily contribute money to retirement accounts. Assets in DB plans are overseen by sophisticated investment committees that retain investment advisors and managers to invest pension plans over many years.

- The freedom of taking loans and withdrawals from DC plans gives employees the opportunity to use DC balances to meet many different financial needs. However, these withdrawals deplete DC assets from retirement needs. Early withdrawals destroy the power of compound interest to multiply the value of early contributions coming into the plan. DB plans fund benefits solely for retirement and employees will have to use other resources to meet other financial needs.

- Longevity is a risk that a DC plan cannot easily overcome. The law of averages and life expectancy don't work for one individual, but only for very large groups. You will die when it's your time and that time is unpredictable. We won't all live to be ninety-five or one hundred. But, in an individual DC plan, many of us will want to save enough to last until very old age to avoid the risk of running out of money. A DB plan gives us a stable income for as long as we live. The only alternative for a DC plan is to buy an annuity which is very expensive when commissions, insurance company expenses and their profits are considered.

- DC plans are great for young employees who have a long time to fund their retirement, but not for older, more experienced and higher paid employees. DB plans allocate relatively more value to the older, longer service and higher paid employees.

- DC plans allow participants to retire early when investment returns are good. As seen in this investment environment, employees delay retirement when investments turn down. This makes it harder for employers to predict when and who will retire. With age discrimination laws, it is hard to let older, less technologically advanced workers go in favor of younger workers. In DB plans, there is a stable retirement income to retire on and a temporary early retirement window can be adopted to encourage workers to retire early.

Let's look at US equity returns over the last half-century. The data indicates that the accumulated real return over any 20-year period depends greatly on which 20-year period is selected. The fund accumulated to the end of 1999 would have been twice as great as the fund accumulated to the end of 2002, and many times greater than the fund accumulated to the end of 1979. How are plan participants to cope with such volatility? They could invest in inflation indexed bonds, but the greater certainty in returns would come at the expense of lower average returns and (therefore) higher contributions. What plan participants really need is a method of intergenerational smoothing, which means that participants who are lucky enough to retire when the market is high sacrifice some of their gains to subsidize participants who retire when the market is low. And this brings us back to the advantages of a DB plan.

The great investment advantage of the DB plan is that it permits the intergenerational smoothing of investment returns. Participants receive a benefit that is independent of actual investment performance over their lifetime. There will be times when the plan is in surplus and times when the plan is in deficit. These surpluses and deficits need not cause difficulties if the plan sponsor is a sound business with a long-term commitment to the plan. Surpluses and deficits can then be amortized over long periods to ensure that the sponsor's contribution is relatively stable. Another advantage of the DB plan is its ability to provide benefits linked to salary. Pension plans are a form of compensation, so it is extremely important to the sponsor that employees place a high subjective value on their benefits. This is more likely to be the case, if the plan provides benefits that cannot be purchased in the market and are linked to perceived needs.

Since employees have little to say, except where unions are involved, many employers have pretty much ignored what's in the best interest of their employees and converted their DB plans into DC plans for primarily two reasons:

1. Cost control, in the sense that an employer's obligation to a DC plan can be predicted up front, based on the contribution formula used, and

2. Easier administration for DC plans along with easier communication of the benefits provided by a DC plan. When CFOs worried about their exposure to DB plans, the transition to DC plans accelerated. Improvements in medical care have allowed many people to live into their 90s, and while extended life spans are undoubtedly a good thing, they extend the liabilities of DB pensions. In an era of historically low long-term interest rates on bonds (which are typically used to fund those long-term liabilities), it's no wonder CFOs began looking for ways to reduce the amount of cash that had to be directed into these plans. CFOs don't like surprises and investment market volatility creates surprises. Converting company pensions to DC plans seemed like a good way to solve those funding issues. After all, in a DC plan, a company is only responsible for making contributions to the account while the worker is employed, which caps the company's liability. Any shortfall or market risk is shifted onto the employee. Also, over prescriptive funding requirements is a strong disincentive for an employer to maintain a DB plan. Regulators should be aware that surpluses and deficits are an inevitable feature of DB pension provision. It makes no sense to force a plan sponsor to meet onerous solvency requirements, if this will threaten the survival of the business on which the plan ultimately depends. The need to cover vested benefits must be weighed against the need to ensure that the survival of the plan and its sponsor are not put in peril in difficult economic periods. Conversely, DB plans should be allowed to maintain large surpluses during a bull market as a margin against the possibility of unfavorable experience in the future. The issue of how DB pension costs should be recognized in the financial statements of the sponsor is a vexing and controversial question. DB plans are a valuable method of compensation and this economic reality cannot be changed by having to report pension costs in a particular way.

DB plans do have their disadvantages. If benefits are linked to final salary, there are potentially undesirable cross subsidies; participants with rapid salary growth and long service obtain more valuable benefits, per year of service, than other groups. These features, however, can be removed by linking benefits to revalued career average salary rather than final salary. The resultant plan structured into a cash balance plan, looks and seems like a DC plan but leaves the investment risk and longevity risk with the employer, since it is a DB plan. This plan design also helps overcome the communication and appreciation of these plans by employees.

DB plans are the most fiscally efficient means of providing a modest but stable retirement income that cannot be outlived. DC plans are important to the retirement security equation, but they were not designed to stand on their own. The evidence is clear – DB pensions provide, as a practical matter, the best path to retirement readiness for ordinary Americans. The shift away from DB pensions in recent years has coincided with a decline in retirement wealth for the typical household, reducing retirement readiness and increasing the risk of hardship in old age. This means fewer working families will have a good chance of maintaining a middle-class living standard in retirement. Thus, rebuilding the promise of retirement security will mean protecting, strengthening, and expanding DB pension coverage for American workers.

In the near term, policy makers should focus on ways to shore up existing DB pension plans. This will require a fine balance between making sure that employers have the right incentives to maintain their DB pension plans, but also contribute enough to the plans so that employees do not have to worry about the security of their promised benefits. Two initial steps seem necessary to achieve this balance.

- First, the rules governing the funding of private sector DB pension plans should be reexamined. The economic reversals of 2001and 2008 produced unprecedented and simultaneous declines in both interest rates and stock prices. Formerly over funded pension plans became significantly under funded. Cash funding requirements and accounting expense charges increased and became less manageable for plan sponsors. And this situation becomes more severe with new funding and accounting rules.

- Second, models of DB pension plan should be designed that insulate employer contributions from shocks, that reduce the possibility of large swings in annual contributions, and that secure employees' retirement benefits. Such designs include, but are not limited to, types of plans like multiemployer DB pension plans in the private sector and multiple employer public sector pension plans. These plans pool resources and contributions.

In the longer term, identifying channels through which new plans can be established or existing plans can be expanded will be necessary. Some of the initial lessons from recent experience in the U.S. and abroad point the direction towards some promising policies. Common to all of these approaches are the pooling of funds across employers, industries and occupations and the role of the government in serving as an incubator for new, well-functioning, secure pensions.

The ability of millions of ordinary Americans to sustain their middleclass standards of living into their retirement years is one we as a nation cannot afford to ignore.

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