By Stephen J. Hoeffner

Twin Crises

The Future of Defined Benefit Plans

Rank-and-file American workers are best served by cash balance plans, and only combined design and funding reform will overcome their negative image and keep these plans viable.

These are certainly interesting times for pension actuaries. After years of toiling in obscurity, we now find ourselves at the center of a national debate over the future of defined benefit (DB) plans.

Employer groups such as the ERISA Industry Committee and the American Benefits Council have been pressuring Congress for current liability interest rate relief. In July 2003, the District Court decision in *Cooper vs. IBM* was so negative that it could all but wipe out cash balance plans. And in late October, a precedent-setting "open letter to Congress," co-signed by most of our CEOs, pleaded for a sensible legislative response to the IBM decision and to the building political pressure to limit hybrid plan conversions.

The CEOs' letter cited the growing number of employers who are, or are considering, freezing DB plan benefit accruals. Since then, my employer, Aon Consulting, has released a survey putting the number at more than 20 percent, and a much broader General Accounting Office report is set to be released shortly.

In the meantime, led by Rep. Bernard Sanders (I-Vermont) and Sen. Tom Harkin (D-Iowa), Congress has nearly completed legislation preventing the Treasury Department from finalizing any new cash balance regulations. This mess—which is nothing less than a DB pension plan design crisis—may take years to sort out.

While our CEOs are to be commended for their efforts, the benefit freezes they cite aren't primarily the result of the gathering pension design crisis. Rather, they stem from an even more threatening pension plan financial crisis, brought on mostly by recent stock market and interest rate declines.

And if our CEOs, while accumulating continuing education credits at last spring's Enrolled Actuaries meeting, were paying close attention during the second and third general sessions, they could have seen back then that both of these crises were looming just over the horizon.

The second 2003 EA meeting general session, dealing with the impact of the recent stock market downturn on corporate financial statements and reflection of investment risk in actuarial liabilities, clearly forecast the gathering financial crisis. The third general session, focusing mostly on the old DB/defined contribution (DC) design controversy, contained a more hidden message: Defined benefit plans were, even then, nearing a design crisis brought on by over-regulation and seemingly endless lawsuits.

It's now becoming clear that these twin crises could, over time, threaten the very existence of DB plans as we know them. Band-aids that only get us past the latest hybrid plan dust--up won't be nearly enough.

I believe—and will try to show here—that both crises result from a failure of American pension law and regulation, and that the only answer is much more fundamental design and funding reform, including a new cash balance regulatory framework and strengthened (yes, strengthened) PBGC guarantees.

The Pension Design Crisis

Let's begin with lessons from the third general session. James Delaplane's (partner, Davis and Harman, LLP) summary of recent congressional activity couldn't have been more insightful—especially his description of comments by a congressional staffer that the best we can hope for is to slow the rate of defined benefit decline. Pension plans seem to have few remaining friends—not liberal Democrats, not conservative Republicans, not most employers or their employees, and not the Bush administration.

To find the roots of the DB design crisis, one need look no further than Mark Beilke's (director of employee benefits research at Milliman USA) defense of DB plans. The DB "advantages" he described were all products of DB plans' extraordinary design flexibility and the effects of DB delayed benefit accruals. (See the now familiar DB/DC benefit accrual pattern comparison below.) These two key features made DB plans enormously popular with large, paternalistic employers of the '50s and '60s, who wanted to encourage and reward career employment, and tailor their pension plans to meet their own specific workforce needs. But these very "advantages" are now potentially fatal flaws.

Most of today's employees aren't much interested in career employment. They don't trust their employers' paternalism, and they want pension benefits they can understand and whose dollar value they can easily measure right now—without reference to how much longer they may work for the company, or how long they may live. No matter what you hear from Rep. Bernie Sanders or from disgruntled long-service IBM employees, the cash balance design revolution reflects nothing more than a good faith response by American employers to this new reality. From an employee relations perspective, traditional pension plans have little remaining appeal.

Design flexibility and delayed benefit accruals may sound like advantages, but they're the kiss of death from a regulatory perspective. Members of Congress, especially on the left side of the political spectrum, have a lot in common with today's employees. They don't trust anything they can't understand—and they certainly don't trust corporate paternalism. To them, DB plans just offer too many opportunities to help the higher paid, and they're not about to hand out tax advantages without lots of rules and regulations.

Almost 30 years of ERISA and post-ERISA legislation have done little to improve benefit portability or to help the rank and file. (It's the cash balance revolution that's doing that.) But Congress and the IRS have succeeded in creating an immensely complex regulatory regime that has driven smaller plans into oblivion and made large plan administration both extremely burdensome and expensive.

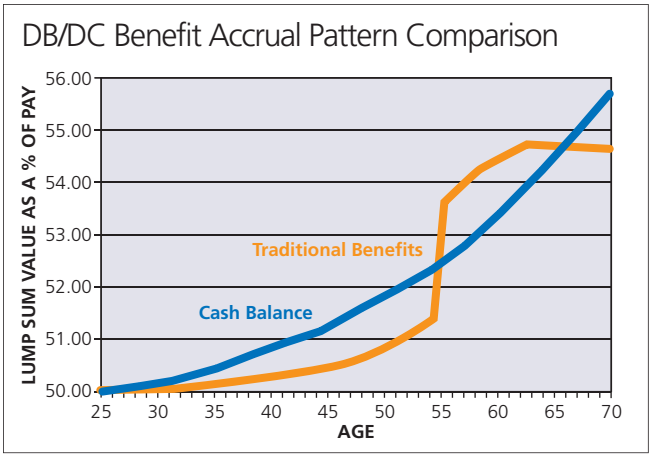
In our courts of law, the complex DB regulatory framework offers predatory trial lawyers fertile ground for creative lawsuits, even—as in the case of cash balance conversions—when most employers act with the best of intentions.

We pension actuaries have gotten so used to the current regulatory regime that it's easy to forget just how complex it is. Here's a true anecdote.

On a flight recently, one of my colleagues was sitting next to a rocket scientist. After hearing my colleague describe our profession, the man thought for a moment and said, "You know, what I do is challenging, but, of course, it isn't pension actuarial science."

What we do is intellectually challenging—and lucrative—but much of it is ultimately nonproductive.

In today's closely divided and extremely contentious political climate, Americans just can't resist the temptation to sue and to over-regulate. A tax-advantaged funding arrangement that's as complex, discretionary, sometimes discriminatory, and potentially even abusive as traditional DB pension plans just doesn't



stand a chance. Tinkering with selected sections of the Internal Revenue Code won't help. The political problem lies at the core of what traditional DB plans are and how they operate.

Because the pension design crisis is primarily a political problem, what's needed is a political solution. We can't just discard the current regulatory structure, but Congress could set up a new structure alongside the teetering old one, for plan sponsors to take advantage of if they wish.

Unfortunately, getting something through Congress that employers will actually use won't be easy, but there is one notable past success: 401(k) plans.

Popularity with employees is the key to success. In today's business world, employers will give their employees anything they really want. But employee appreciation is also the key to political support. Congress will never mess with (k) plans, in part because workers are also voters, but there's more to it than that. I think Congress wants to see the same features that employees value: simplicity, transparency, no undue favoritism for the highly paid, and (probably) limited employer flexibility and discretion.

Regulatory flexibility helps keep pension actuaries in business, but finding ways around ever more complex rules can become an addiction. No one wants to tell senior management that a particular design objective can't be accommodated—and we all pride ourselves on our creativity. But historically the IRS response has usually been to up the ante still further, and compliance costs continue to escalate.

Simplicity, transparency, predictability, popularity with employees—all these point straight at cash balance plans as the key to successful defined benefit reform. But that reform will come only with a price—and it seems to me that price is probably cash balance safe harbor design parameters that limit employer discretion to offer many of the more popular features of traditional DB plans.

I don't need to describe the chaotic state of current cash balance plan regulation. Beyond some half-hearted efforts at safe harbor rules—Notice 96-8, the 401(a)(4) regulations, and the recent Section 411(b)(1)(H) fiasco—the IRS has been unable to develop a consistent cash balance regulatory framework. Wearaway provisions, backloading rules, whipsaw calculations, transition practices, age discrimination requirements, interest crediting rates, equity indexing, and many more issues all need clarification. Pension law needs a complete cash balance makeover, and the pension actuarial community should take the lead in its development.

Now let's step back for a moment. Aside from the professional self-interest of pension actuaries, why resuscitate DB plans at all? Couldn't (k) plans take over just as well? The EA Meeting's second general session, after dishing out lots more bad news for DB plans, answered that question with a resounding "no." And, I think, it also pointed in the direction of cash balance-based legal reform.

The Gathering Financial Crisis

The primary subject of the second general session was reflection of investment returns and portfolio risk in corporate financial statements, and in actuarial liability measurement.

John Foster, a member of the Financial Accounting Standards Board (FASB), described the FASB's concern that corporate financial statements may not be sensitive enough to changes in pension plan funded status—especially the impact of short-term investment gains and losses. Needless to say, any rule changes in response to these concerns would make DB plans even more unpopular with today's risk-averse corporate CEOs than they already are.

Lawrence Bader (former managing director at Mercer Human Resources) and Jeremy Gold (a consulting actuary) have written a controversial paper suggesting that pension liabilities, calculated at high equity-return-based interest rates, are generally understated. Gold wisely confined his presentation to taking questions, but his point was clear enough. The higher expected average investment returns that come with increasing equity exposure also increase the range of likely return variation. This increased range creates additional risk, which suggests the need for additional, compensating actuarial reserves.

Contrary to almost universal current practice, not to mention the funding requirements of ERISA, Bader and Gold argue that increasing equity exposure should not necessarily reduce—and perhaps should even increase—measured pension funding liabilities.

Another speaker, Michael Peskin (managing director at Morgan Stanley), believes that plan sponsors should be encouraged to prudently immunize their DB plan liabilities through matching bond investments. In his view, companies that fail to do so should be required to disclose the true nature of their retained investment risk—presumably with dire consequences for their share prices.

Yes, pension liabilities do behave the way long-term bonds do, but, from the employee's perspective, so do benefit values. In traditional DB plans, participants, in effect, take on bond investment risk. But under current practices, the level of benefits

does reflect what the sponsor believes is supportable by equity investment returns.

In a more prudently funded pension system, apparently only bond investment returns would be available to help finance pension benefits. Bond investment risk (and underlying bond investment returns) is about the same deal employees could arrange for themselves by investing their own DC accounts in bonds—and clearly a formula for DB extinction.

Peskin views cash balance plans with alarm because their stable benefit values force the plan sponsor to take on investment risk that cannot be immunized. But this line of reasoning also suggests that cash balance plans are a pretty good deal for employees, offering stable benefit value with no investment risk and financed—at least under current practices—by anticipated equity investment returns.

If you believe Bader, Gold, and Peskin, pension plans are today even less well funded than we thought. But even if you don't agree with them, it's clear that the recent stock market downturn and today's low interest rates are going to further damage the reputation of DB plans in the eyes of senior management.

Peskin related a telling anecdote. The CEO of a large DB plan sponsor described his organization as a medium-sized, well-run, profitable company harnessed to a very large casino. No matter how well this CEO ran his company, its long-term success was tied directly to pension plan investment returns (the casino). Many of us have encountered similar views.

In seeking to place blame for this looming financial crisis, pension actuaries have several tempting targets: the FASB, whose Statement No. 87 has never really been tested in a down market; actuaries such as Bader and Gold who insist on pointing out the obvious; or perhaps even the Bush administration for failing to deal with the 2001-2002 economic downturn. But, as with the pension design crisis, the real culprit is the current pension regulatory regime. And once again, the solution is a new framework more supportive of cash balance plans.

A fundamental tenet of ERISA is that pension funds are separate entities, the assets of which must be used for "the exclusive benefit of plan participants and their beneficiaries." But there's no "exclusive benefit rule" when it comes to stockholders or corporate assets. If investment losses leave a terminating pension plan underfunded, participants, and if necessary the PBGC, have first call on the sponsor's assets. In the meantime, the Deficit Reduction Act accelerated a funding requirements kick-in to further protect the PBGC.

Given these funding rules, can we blame the FASB for seeing less and less difference between pension plan and general corporate assets and liabilities—and for structuring accounting rules accordingly? And can we blame corporate CEOs for not wanting to take on investment risk, especially when that risk can just as easily be passed on to employees through 401(k) plan enhancements?

Michael Peskin's presentation included a list of the 10 American companies with the largest ratios of pension liabilities to market capitalization. The future of these companies is directly related to the financial health of their pension plans. As Peskin's worried CEO recognized, under current funding rules, few would survive a 10-year or perhaps even a 5-year down stock market—no matter how well they managed their core businesses.

A DC Alternative?

In today's highly competitive business environment, companies rise and fall with sometimes surprising speed. ERISA and post-ERISA legislation, which first created the PBGC and then attempted to limit its financial exposure, has made it increasingly difficult for DB plan sponsors to take on equity investment risk on behalf of their employees. It may not be long before employees who hope to benefit from long-term equity investment performance will have only one alternative: assume the investment risk themselves in DC plans.

This is exactly what the Bush administration, and apparently many political conservatives, have in mind. Look no further than President Bush's "Lifetime Savings Account" and "Employer Retirement Savings Account" proposals to appreciate

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the administration's preference for self-established, after-tax, DC-style retirement funding.

Brian Perlman's (vice president, Mathew Greenwald & Associates) excellent presentation at the third general session provided strong arguments against the administration's approach. His polling shows that most Americans have no idea how much money they'll need in retirement and are saving at woefully inadequate rates. As they near retirement, most will have little if any margin for investment losses and won't be able to take advantage of equity investing the way their employers used to in DB plans.

In a world without DB plans, the rich will get richer—in part because only the higher-paid employees will be able to afford significant equity exposure in their DC account portfolios.

Contrast this with cash balance plans that need only modest regulatory relief from the IRS's wrongheaded interpretation of Sec. 417(e) to credit interest at rates that mirror average anticipated equity investment returns.

That's right, individual accounts and equity-related interest credits, but with very limited equity investment risk to employees. It's a seemingly impossible combination, but one that cash balance plans can deliver with ease if the U.S. Congress can just get beyond the negative publicity over the IBM and other cash balance conversions and pass some enabling legislation.

Rank-and-file employees are also at far greater risk of outliving their DC accounts. The higher paid can afford to take on mortality risk; the lower paid cannot. In a DC plan, the only way to mitigate mortality risk is through an annuity purchase—which means accepting significant risk and administrative charges, as well as extremely low underlying interest rates tied to an insurance company's fixed income investment portfolio.

Contrast this with what cash balance plans could provide as annuity payouts—again with just a simple reinterpretation of Code Section 417(e): an underlying interest rate tied to equity investments, no risk charges, and administrative costs picked up by the plan sponsor. Of equal importance—and unlike traditional DB plans where subsidized early retirement factors virtually force immediate benefit commencement—retirees could retain almost total flexibility to begin payments whenever they wanted, and even to vary the level of payments to coordinate with other sources of retirement income.

Cash Balance Funding Reform

I doubt that anything can save traditional DB pension plans. They simply have no remaining employer-based constituency. Much better to complete the half-finished, and now greatly endangered, cash balance revolution.

But this will take more that just design-based legislative reform. Just as important will be fundamental cash balance plan funding reform, because nothing else can rescue DB plans from their worsening reputation among corporate CEOs and CFOs for financial unpredictability and risk.

In today's volatile economic climate, even the largest and strongest American corporations may be unwilling—and, in fact, unable—to take on the enormous equity investment risk required to maintain a viable DB plan. There's only one answer. The federal government must, through an expanded financial commitment to the existing PBGC, step up and assume much of the long-term risk that cash balance plan equity investments will significantly underperform historical averages. Corporate sponsors must be relieved of this responsibility through new funding rules that require only very gradual recognition of investment performance-related shortfalls.

I fully recognize that the current DB debate in Washington is moving in exactly the opposite direction, seeking ever stronger financial safeguards for the PBGC. But there is no alternative to increased government guarantees if the retirement savings of average American workers are going to benefit from the same equity investment opportunities as those of their less risk-averse, higher-income colleagues.

A cash balance plan in which employer contributions closely track aggregate annual pay credits, where interest credits mirror conservatively selected ERISA funding interest rates, and where annuity payouts are the norm, should rarely (if ever) develop significant long-term underfunding. Only a prolonged failure of American equity markets—similar to what has happened in Japan and much of South America—would change that.

The root causes of the Japanese and South American experiences are much more political than economic. Similarly, under reformed cash balance funding rules, widespread significant underfunding is not going to result from normal stock market ebbs and flows but only from a catastrophic failure of American political leadership. Is it so unreasonable to expect the federal government (i.e., the PBGC) to deal with the consequences of such a failure? I don't think so.

In the current situation, we pension actuaries have our work cut out for us. But even as we join the impending political struggle to salvage hybrid plan designs, we shouldn't lose sight of more fundamental problems, especially on the investment side. Because Bader and Gold are right that the current DB system is financially unsustainable. Rank-and-file American workers are best served by cash balance plans, and only combined design and funding reform will keep these plans viable. It's up to us, the American pension actuarial community, to deliver that message. ●

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