

## **Simplifying the Transfer of DB Assets to Defined Contribution Plans Would Encourage a More Orderly Transition to DC Plan World**

*Market Fluctuations and Accounting Changes Will Cause More Employers to Terminate DB Plans; Encouraging Direct Transfers to DC Plans Would Bolster Retirement Savings*

Employers have terminated nearly 61,000 defined benefit pension plans since 1990. The vast majority of these plans, approximately 97 percent, were fully funded at the time of their termination. For these so-called “standard” terminations, employees typically received a lump sum representing the present value of their accrued pension benefits. However, with such terminations comes the danger that workers will compromise their retirement by failing to invest any lump sum payment from the terminated plan into an appropriate retirement savings vehicle. While many beneficiaries undoubtedly invest their lump sum in an individual retirement account (IRA) or even purchase an annuity, others may instead choose to spend their distribution for non-retirement purposes. In its monograph, *The Future of Retirement Security: Challenges Facing Working Americans and the Companies They Work For*, HR Policy recommended legislation that would simplify the process of terminating a fully funded DB plan by permitting employers to automatically transfer the accrued benefit into the employee’s defined contribution account. This would encourage a more orderly transition to DC plans, reduce employee anxiety and enhance retirement security overall.

**Regulatory Costs and Volatility Cause Large Employers to Consider Freezing or Terminating Their DB Plans** Although DB plans are among the most efficient ways to provide for a secure retirement, a number of factors, most related to cost, are causing employers to consider freezing or terminating their DB plans. Overall, the costs of maintaining a DB plan are over 210 percent greater than maintaining a DC plan. Moreover, recent increases in short-term market fluctuations make it difficult to plan sufficiently in advance for additional contributions and can negatively impact business plans. The impact of this volatility will be amplified by accounting rule changes that will require companies to show plan overfunding or underfunding on their balance sheets for the first time starting in December 2006. Pending changes in pension funding rules will increase required contributions and recent increases in pension insurance premiums that DB plans pay to the Pension Benefit Guaranty Corporation (PBGC) will increase the costs of maintaining a DB plan.

**DC Plans More Attractive to Younger Workers Than DB Plans** Another reason companies may consider freezing or terminating a plan is that while DB plans are generally effective in retaining long-term employees, they are not attractive to younger employees who are not likely to stay as long. According to the Employee Benefit Research Institute, men and women ages 25 to 34 have median tenures of 3 years and 2.9 years respectively, generally not long enough for their benefits to vest under most DB plans. By contrast, such workers could start to accrue benefits under a DC plan, and they find such plans easy to understand. Hybrid plans that are DB plans that have attributes similar to DC plans, such as cash balance plans, are more popular with younger employees. However, recent court decisions finding that the cash balance design violates ERISA have caused many employers to avoid adopting such plans. Even

without the potential legal questions, employers that have adopted those plans are still subject to many of the same volatility issues that plague traditional DB plans, although to a lesser extent.

### **Most Employers Changing Plans Freeze the DB Plan and Create a Separate DC**

**Plan** Currently, employers changing from a DB to a DC retirement plan typically freeze participation in their DB plan and create a separate DC plan. Employers may freeze DB plans either by closing participation to new employees and continuing its operation for all other employees (a soft freeze) or closing participation to all employees after a certain date (a hard freeze). Regardless of the type of freeze, the employer only limits liability far in the future because it must manage the plan until the final participant dies, and shoulder the investment risks, including market volatility and the other costs discussed above. This can last as long as 80 years in some cases, depending upon the employee population in question.

### **Terminations Likely to Increase as Employers Seek to Limit Negative Effects of Maintaining a DB Plan**

Because the costs of continuing to operate a DB plan are substantial and uncertain – even for plans closed to new employees – it is possible that many employers with fully funded plans will seek to terminate their plans rather than freeze them. In contrast to freezing the plan, an employer may terminate a fully funded plan by paying all accrued benefits to employees in a lump sum using more advantageous PBGC assumptions, or by purchasing an annuity for them. Although terminations are costly, they enable employers with fully funded plans to cut off the investment and volatility risks, PBGC costs and other costs associated with DB plans. The employees avoid the potential of losing part of their accrued benefit due to employer insolvency and have the potential to roll over the amounts into another retirement plan, such as an IRA. However, employees still possess the ability to use the funds for purposes other than retirement.

### **Facilitating DB to DC Conversions Would Improve Retirement Security by Keeping Accrued Amounts in an Employer-Based Retirement Account**

One way to reduce opportunities for “leakage” during the termination process and create a more orderly transition from the DB system to the DC system is to create a statutory mechanism that employers could use to transfer accrued pension benefits directly into an employee’s DC account. In an ideal scenario, employers with a fully- or over-funded plan would simply place existing accrued pension benefits into their employees’ 401(k) accounts or other DC plans. However, there are legal and regulatory issues that must be addressed. For overfunded plans, the tax code imposes a 35 percent income tax and a 50 percent excise tax penalty if the money is returned to the employer. In addition, ERISA prohibits employers from changing the rights and benefits associated with amounts in a DB plan when they are transferred to another plan. To address these concerns, Congress would have to pass legislation creating a safe harbor for DB to DC transfers. This would allow employers to eliminate fiduciary liability for managing their DB plans. More importantly, it has the potential to make a more orderly transition between traditional DB plans and the newer DC environment by creating mechanisms that encourage employees to retain and grow retirement funds, as well as making those amounts last in retirement.