

After DB, What's Next?

JUST AFTER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) was signed into law in 1975, 40 percent of the labor force participated in a defined benefit (DB) plan, and 16 percent participated in a defined contribution (DC) plan. Today, however, the reverse is true, only 20 percent participate in a DB plan, while 43 percent participate in a DC plan.

Earlier this year, I attended a pension symposium, held as part of the 2006 Enrolled Actuaries meeting. During the symposium, approximately 100 actuaries from various backgrounds discussed issues ranging from funding reform legislation to investment practices, from annuitization of DC account balances to the next generation of retirement programs. One of the most often repeated questions, however, was “What happens after DB plans?”—indicating a belief that traditional DB plans are dying.

Whether influenced by the perfect storm of 2000–2003—a change in workforce dynamics, or a myriad of other demographic and economic factors, the trend is obvious: The percentage of the labor force covered by DB plans is diminishing, and DB plans, with the possible exception of small plans and collectively bargained plans, are being frozen faster than new ones are being created.

Why? Defined benefit plans have for many decades provided a guaranteed lifetime income in retirement, and are more effective than DC plans at addressing most of the risks associated with retirement. For example:

- **LONGEVITY RISK.** DB plans provide a guaranteed lifetime income. While DC account balances can be annuitized, workers very rarely take this option.

- **INVESTMENT RISK.** There is a certain degree of control inherent (or at least perceived) in investing one’s own money in a 401(k) or other personal savings plan, but there is also more risk. In DB plans, the employer takes on the risks associated with market declines and low interest rates, plus the PBGC guarantees those pensions should an employer enter bankruptcy.

- **LEAKAGE RISK.** Boats are fun, but they won’t keep you afloat in retirement. Most DB plans still provide annuities upon retirement, but in DC plans, workers can (and often do) withdraw their money, either spending it before they retire or mismanaging it after.

- **CONTRIBUTION RISK.** DB plans typically cover all employees, except part-time and temporary employees. In 401(k) plans, however, employees may not or cannot contribute, leaving them without a benefit at retirement.

While DB plans effectively address these risks, and oth-

ers, we have to recognize that they face challenges when compared with 401(k)-type arrangements, which are often perceived to be more flexible, more portable, and better at providing potentially higher investment returns.

Many people argue that younger workers don’t appreciate DB plans for a variety of reasons, resulting in a lack of demand for these types of plans. I’ve often argued that statements such as these don’t give younger workers enough credit. I believe they do recognize the value of these plans, but they’re faced with a different retirement reality from that of their parents: They don’t stay in the same job for 30 years, they do want more control over their investments, and they have less faith in the reliability of programs like Social Security and Medicare. But, look for that to change when the first generation of workers overwhelmingly covered by some type of defined contribution plan moves toward retirement.

Imagine those workers with no employer-provided pension, no guaranteed lifetime income, little personal savings, and no option but to work past normal retirement age because they don’t have a sufficient retirement income. What happens when they eventually do have to retire and end up relying on their children for support? As soon as Mom and Dad move in, the need for a secure retirement income will seem a lot more desirable to those younger workers.

There is also, of course, the shock of a market decline, or even a crash, that could force people to recognize the 401(k)’s inherent instability. For example, my parents suffered losses to their 401(k)s when the market dropped in 2000. Because of my risk-averse nature, I’ve never envisioned myself becoming a “401(k) millionaire.” However, witnessing the financial setback they experienced, knowing that they may have to work longer and save even more in preparation for their nearing retirement, was my wake-up call to the need for a more predictable and secure retirement plan.

Arguably, no matter the exact reason, we can expect to see younger workers begin to demand the type of retirement security their parents, or more likely their grandparents, were accorded.

Instead of the traditional final-pay DB plan, though, we might expect to see plan designs that provide an alternative to our parents’ DB plan, such as:

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■ **DB-K**, a defined benefit plan with 401(k) features. DB-K plans would comply with rules and regulations governing traditional DB plans but could include a number of traditionally 401(k)-type features. Proposed modifications include allowing voluntary, pre-tax employee contributions, allowing employer matches, allowing employers to provide higher rates of return on employee contributions, providing automatic default elections, and providing employees the ability to receive in-service distributions at age 59½. Since it's fundamentally a defined benefit plan, there would still be a PBGC guarantee.

■ **CASH BALANCE PLANS.** These plans have features of both DB and DC plans, but they face a number of obstacles because of their structure. Cash balance plans differ from 401(k)s in that the employer specifies not only the contribution but also the investment return. If an employer specifies an investment return greater than the 30-year Treasury rate, the whipsaw calculation becomes a factor. And many accuse cash balance plans of age discrimination.

While many cash balance plans have been successfully implemented, legal action surrounding a few more high-profile cases, particularly conversions, has created a challenging environment for these plans. Though their portability and account balance design make them a viable alternative to traditional DB plans, it's unclear whether they'll be able to overcome the negative press that has portrayed them in recent years.

■ **CAREER-AVERAGE DB PLANS.** Unlike final-pay plans, career-average plans pay a benefit based on a worker's average earnings over the period in which she's covered by the plan. These plans are typically less costly for employers than final-pay plans and tend to be more predictable. Since it's a traditional DB plan, the lifetime income component is still present.

Recent trends show an increase in the use of this plan design, primarily because the cash balance plan is a type of career-average plan. One distinct difference is that cash balance plans are automatically indexed.

As a practical matter, none of these plans, or even a more creative, outside-

In the past several years, the media have been especially harsh with respect to the recent failures of employer-sponsored pensions. Rarely, however, do we hear or see reports that focus on the many successes of the system. The Academy's Pension Practice Council, in conjunction with the Society of Actuaries, recently sponsored a Capitol Hill briefing addressing the public's knowledge of retirement and the risks associated with retirement. As part of the briefing, and in an attempt to counter some of the recent negative news reports, Anna Rappaport took the opportunity to point out some of the successes, in addition to a number of failures, of the current pension system.

The following essentially provides a roadmap to the future of retirement security. If we can develop a plan that maintains current successes but adequately addresses the failures, then a secure retirement for future generations may be more a reality than theory.

SUCCESSSES	FAILURES
Many people can choose to retire	About four in 10 retire before they choose—premature retirement often due to job loss, poor health
Major reductions in poverty rates among elderly couples—now about 5 percent	Poverty rates much higher for widows, divorced, single older women—15 percent to 20 percent range
Employer system has accumulated \$11 trillion in assets—good benefits for long-service people in many companies	Many working Americans do not have employer coverage
Employer system results in benefits and savings for millions of Americans who would not have anything other than Social Security without employer plans	While many companies and industries have done well, others have not and bankruptcies have led to job loss and frozen benefits; DB plans are being frozen or terminated
Social Security benefits—major impact on older, disabled Americans plus survivors	DB funding rules designed to balance benefit security and tax-deductible limits haven't worked well under difficult economic scenarios (perfect storm)
Many people are happy in retirement today	Rules for cash balance plans not clarified
DB plans provide lifetime income for many retirees today—vast majority of these plans pay benefits as promised	Substantial gaps in financial literacy and retirement knowledge, and Americans do not save well on their own
Housing values important for retirement wealth	Some DB plans are underfunded today, and PBGC is facing financial difficulty
PBGC insurance protects a moderate level of defined benefit plan benefits	PBGC guarantees do not protect entire DB benefit (which some people would consider appropriate)
While Americans do not save well on their own, they have come to expect to save in 401(k) plans, and 70 percent to 80 percent who are offered plans participate	People save in 401(k) plans, but many stay in default options, use money too early, and do not invest well
	Mobile employees do not fare well in final pay DB plans

the-box-type of design just waiting to be developed, would provide the only and best option for a secure retirement. As is often repeated, the best retirement planning strategy is based on a combination of an employer-sponsored retirement plan, Social Security, and personal savings (the classic three-legged stool).

Having worked in this area and with actuaries for a number of years, I fully understand the value of defined benefit plans. At the same time, however, I recog-

nize defined benefit plans alone won't solve the impending retirement crisis. What we need is a broader national retirement security policy that will take the best of the three-legged system, improve upon its limitations, and evolve with the needs of future generations.

So, what happens after DB plans? Maybe the better question is: How do we develop a strong national retirement policy? When put to the test, I'm sure actuaries can come up with something. ●