

The Real Truth About Defined Benefit Plans

DEFINED BENEFIT (DB) PLANS are clearly not as popular today as they were 30 years ago. Though there may be many reasons, the explanations commonly given for this apparent demise have been repeated so often and by so many different “experts” that they are almost universally accepted as gospel truth regardless of their validity. Unfortunately, even those who might be able to offer a strong contrary view are repeating the same tired arguments against these plans. For example, consider the reasons listed below, which are taken from Mark Shemtob’s article in the July/August 2007 issue of *Contingencies* magazine, “The Truth About Defined Benefit Plans.”

- 1) DB plans aren’t in the best financial interest of employers.
- 2) When employers consider the potential financial impact of a DB plan, it’s abundantly clear that defined contribution (DC) plans are the better choice.
- 3) As the cost of DB plans (for state and municipal employees) increases and requires higher taxes, their continuation will become more difficult to justify.
- 4) Many nonprofits have looked into changing their DB plans in response to pressure to reduce administrative overhead.
- 5) Under a DB plan, the investment risk is fully assumed by the employer that funds the plan.
- 6) Poor investment performance will necessitate additional contributions and will divert funds that could have been used for research and development and other business needs.
- 7) The overall expenses of maintaining a DB plan are generally much higher than for a DC plan and must be sustained by the employer.
- 8) Pension Benefit Guaranty Corp. (PBGC) premiums can be extraordinarily high for a plan that’s underfunded.
- 9) There are no actuarial fees or PBGC costs incurred with DC plans, and any other reasonable administrative costs can be paid by participants.
- 10) Many employees no longer express strong dissatisfaction with their employers when they terminate a traditional DB plan.
- 11) The career employee has become rare, with most individuals working for many different companies over the course of their careers.
- 12) The inherent portability offered by DC plans makes them more suitable for a mobile workforce.

All of these arguments can be categorized as variations on one of two themes or as weak attempts to justify preconceived but unfounded notions about the differences between DB and DC plans. Under this type of thinking, the comparison between plans devolves as follows: DB plans are too expensive and too unpredictable, but even if that weren’t true, employees don’t like them because they believe DC plans are inherently better. And so, the reasoning goes, ditch the DB plans.

Registering a Different Opinion

There is, however, a strong contrary view that has been largely hidden from the general public or, if not hidden, then dismissed as unbelievable. Consider, for example, the following “surprising” statements:

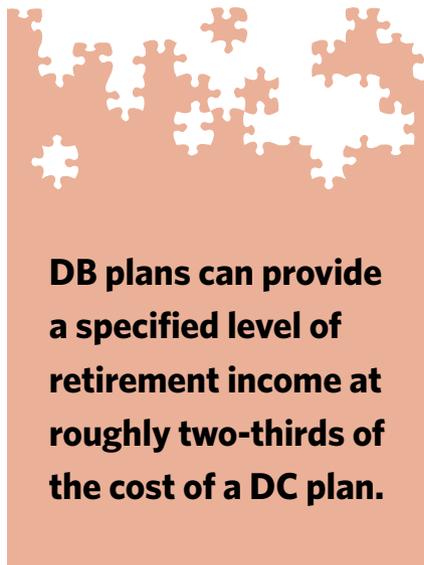
First, DB plans are more efficient (and, therefore, less costly) than DC plans in providing covered employees with comparable levels of retirement income. There are two components to the cost of any benefit program. By far, the largest component is the cost of the benefits



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themselves. The other is the cost of administration. With regard to benefit costs, there are two issues that should be a part of the discussion. One is obvious, the other isn't, but both are almost always ignored when this topic is being addressed. The obvious point is that when an employer replaces a DB plan with a DC plan that is clearly less costly, benefits have been cut. For inexplicable reasons, though, the prevailing attitude seems to be that superior investment returns in the DC plan will not only make up for lower employer contributions but will somehow generate even larger benefits than were available in the DB plan! Very few managers seem willing to admit the obvious, that benefits (in the aggregate) have been reduced as a result of plan conversions of this type.

The not-so-obvious issue is that of "wasted dollars." If the primary purpose of plan sponsorship is to provide employees with a source of retirement income, any benefits distributed in the form of cash



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payments before an employee attains retirement age (i.e., lump-sum distributions paid to terminating employees) are wasted dollars. One might argue that some of these payments are rolled over to IRAs and held for retirement, but the percentages rolled over are disappointingly low. In any event, the difference between wasted dollars in DC plans compared with DB plans having a lump-sum op-

tion is roughly one-third of the total of all amounts distributed. This means that DB plans can provide a specified level of retirement income at roughly two-thirds of the cost of a DC plan. When I've made this statement to clients, most react with total disbelief (except when they've allowed me to conduct a replacement-ratio study to show what level of contributions would be required in a DC plan to duplicate the benefits being provided in the DB plan). What's even more disturbing is the prevailing notion that employees can invest a smaller employer deposit in their DC plan and achieve better returns on investments than they would enjoy in the DB plan (with the end result of retiring with a larger benefit). This view is common, despite the fact that studies consistently reveal that professional investment managers achieve higher rates of return on assets than individual employees and that most DB plan assets are professionally managed.

With regard to the administrative cost,



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the generally accepted wisdom is that DC plans are much cheaper. After all (or so the argument goes), these plans have no actuarial fees to pay and no PBGC premiums. However, what isn't said is that DB plans don't have the excessive costs associated with daily access to account balance information and the added costs associated with the extra employee-education materials that are usually provided with these plans. My firm provides broad-based actuarial services to DB plans and daily valuation services to employee-directed DC plans. It's been our experience that the administrative fees for a daily valuation DC plan are significantly higher than the actuarial and related fees for a comparably sized DB plan. It's only when PBGC premiums are added that DB plan fees exceed DC plan fees—and then by only a small margin unless the DB plan is underfunded and must pay the PBGC risk premium, which brings us to another point.

Rarely mentioned in these discussions is the fact that some DB plans are exempt from PBGC coverage (small plans sponsored by professional service corporations and all governmental plans) and that well-managed plans don't pay risk premiums.

The ultimate conclusion to be drawn from these arguments is that the overall cost of a well-managed DB plan is much less than the overall cost of a DC plan (one that provides comparable benefits at retirement) because of the huge benefit cost advantage. Furthermore, the excess administrative cost of a DB plan, if in fact there is such an excess, is inconsequential. And, if the DC plan truly is less costly, then it provides a smaller benefit.

Second, the single biggest cause of the cost unpredictability for DB plans isn't their inherent nature, but rather poor management. Admittedly, another contributing cause of unpredictability is the effects of government regulation and accounting requirements that are often counterintuitive, but even these can often be resolved through good management practices. Based on more than 30 years in the pension industry, it's been my experience that well-managed plans generally have stable and predictable costs, they don't pay PBGC risk premiums, and they

provide significant benefits to retirees who genuinely appreciate them. On the other hand, plans managed with a "minimalist" mentality (meaning they are consistently funded at minimum required levels and plan assets are directed toward riskier investments with the hope of generating substantial gains to lower costs) tend to run into the problems described above (i.e., increasing cost, wide fluctuation in required funding, high PBGC premiums, low satisfaction). The key to good management starts with a plan design that's affordable for the long-term, is funded at reasonable (not minimum) levels, and has appropriate restraints on taking investment risks. Plans that have followed these practices are generally well-funded, stable, and healthy.

Third, some of the reasons used to denigrate DB plans are no more than urban legends. These reasons include the ideas that (1) employees don't care about the termination of their DB plans or don't appreciate the benefits provided by them; (2) the career employee is rare, so DC plans are more appropriate; (3) DC plans are portable and DB plans aren't; and (4) it's obvious that employees will get better benefits from a DC plan than they will from a DB plan.

If employees really don't care about plan terminations, or don't appreciate or recognize the value of these benefits, then why were major lawsuits instigated when IBM and others tried to change a traditional DB plan into a cash balance plan? Or why was there so much resistance to President Bush's idea to privatize Social Security with individual accounts? Whether or not employees understand the complexities of actuarial calculations or the time value of money, they consistently display an innate understanding that they lose something significant when their employer's DB plan is terminated. And if they are given a fair and reasonable presentation of the impact of a change from a DB to a DC plan, the resistance to conversion rises appreciably.

The statement about no more career employees is also frequently heard, but why, then, do the age and service charts that are included in actuarial valuation reports show significant percentages of

employees with 15 or 20 or 30 or more years of service? There are far more career employees in the workforce than these statements acknowledge.

Then there's portability. What is this, really? In the vernacular, it seems to mean, "I can't have my money from the plan **now**, to spend how I please and when I please." Or, "Because I can't have it **now**, it's sitting somewhere and not growing, so it's a useless or irrelevant benefit. If I had the money, I could at least invest it to make it worth something." But if the issue is immediate access, then the money shouldn't be considered retirement money, because most money that's readily accessible is spent and not used for retirement. Furthermore, the idea that a deferred annuity is not "growing" is based on a false premise that denies the time value of money.

Finally, there's the misplaced notion that DC plans will almost certainly grow beyond whatever value a benefit may have in a DB plan. In my experience, this argument has often come from investment advisers who exhibit little understanding of the symbiotic relationship between asset growth and wage growth, and is presented in a fantasy world that ignores the reality of variability of returns and risk. (One such presentation made to one of my clients by an organization promoting DC plans used projections based on compounded annual returns of 10 percent on assets but only 2 percent annual growth in pay!)

One of the reasons for the demise of DB plans that was stated above, without any supporting facts, is that "it's abundantly clear that DC plans are the better choice." Tragically, what is abundantly clear is that those of us who realize the value to society of employer-provided DB plans are giving in without a fight. We seem to be content to stand by and watch them die, even though we know they could still be a cost-effective and efficient tool in providing retirement income to an aging population. ●

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