January 2015

Milliman

DB digest

Best Practices for Pension Administration

UPCOMING KEY DATES

1/13/15

Post 2013 Form 5500 (Annual Return/ Report of Employee Benefit Plan) basic plan information and 2013 Schedule SB (Actuarial Information) on the plan sponsor's existing intranet site, if 2013 Form 5500 was filed on 10/15/14; if filed prior to 10/15/14, the deadline is 90 days from the date of the filing.

1/31/15

Pay to participants the increase in monthly age-70-1/2 required minimum distribution (RMD) to reflect additional benefits accrued in 2014.

2/2/15

Provide 2014 IRS Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) to recipients of 2014 distributions.

2/14/15

For any plan that last provided the triennial benefit statement for the plan year ending 12/31/11, provide the triennial benefit statement to participants.

3/31/15

If the 2015 AFTAP is not certified by 3/31/15, the 2014 AFTAP minus 10 percentage points is deemed to apply for purposes of triggering IRC section 436 benefit restrictions beginning 4/1/15 and until a subsequent certification determines whether the plan's funded ratio is sufficient to remove the benefit restrictions.

Are Pensions Dead?

David Benbow, CPC

During the last few decades, there has been much talk about the demise of the defined benefit (DB) pension plan. I've been administering pensions for a quarter century and have seen many legislative and economic changes during that time. Because my livelihood has depended on DB plans for my entire career, I'm holding out hope that they still have some life left. Still, no one can say with certainty what will become of them. Are they dead? Will they freeze, one by one, and be terminated or will they re-emerge in a new form (such as longevity plans)?

To put these speculations into some context, let's travel back to the frontier days of pensions, before ERISA.

The year is 1970. A gallon of gas costs 39 cents. People are bemoaning the breakup of the Beatles and mourning the deaths of Jimi Hendrix and Janis Joplin. Internal Revenue Code Section 401(k) would not exist for another eight years. DB plans exist, but are largely unregulated.

Opening the time capsule

Wendell Milliman started his Seattle actuarial firm (which still bears his name today) in 1946. As the firm grew and expanded, it established an office in San Francisco in 1956, headed by an actuary named Bill Halvorson (who also later established a Milliman office in Milwaukee). Bill has long since retired, but I recently had an opportunity to read an article he wrote in 1970.

Bill Halvorson

This pre-ERISA article looks 30 years into the future and Bill imagines himself discussing the state of pensions with another retiree in the year 2000 over a game of horseshoes.

The name of the article was "Pensions Are Dead."

Bill elaborates by saying, "They didn't die, they were killed!... It was a slow strangulation, and the victim went down slowly, if passively, so hardly anyone looks at it as a killing." Reading this article from 1970 is like opening a time capsule. And, while Bill Halvorson didn't predict everything that would happen to pensions, he did say a few things that ring very true nearly 50 years later.

Bill speculated that Social Security would spiral out of control and that if pensions integrated with Social Security, they would be diminished. This would lead to the emergence of savings plans, thrift plans, and profit-sharing plans as the only viable way to supplement expanding Social Security.

Bill also suggested that funding regulations would strangle private pensions. In a statement that seems radical to someone like me, who has always known funding rules, he said:

> *…Unfunded liability was what permitted pension plans to be the "Super-savings" plans—in other words, by creating large unfunded liability, both on the date the plan started as well as at the time of substantial improvement in benefits, employers were able to make up for their past failure (or inability) to put enough money aside to pay for currently needed benefits.*

Bill claimed that a healthy unfunded liability was good for pension plans and for participants as well.

What would the PBGC say (or what would it have said if it had existed in 1970)?

Of course, the fundamental flaw with large unfunded liability is that it requires the pension plan to live forever in order to continue paying benefits. The Studebaker pension plan terminated in 1963 and left thousands of employees with substantially reduced pensions. And, as radical as his ideas seem in today's environment, Bill Halvorson would later go on to become president of the Society of Actuaries in 1977 and the American Academy of Actuaries in 1982.

Back to the future

Returning to the present day, pension plans have not died, as Bill Halvorson predicted, but they are on life support. A recent paper entitled "Cultivating Pension Plans" by John M. Vine of The Wharton School's Pension Research Council describes the simultaneous cultivation and regulation of DB plans and spins the overregulation of DB plans as a positive thing–for defined contribution (DC) plans.

Just as Bill Halvorson's article looked 30 years into the future of DB plans, John Vine's paper chronicles the last 30 years:

> *In the past 30 years, very few private sector employers have adopted new DB plans, and many sponsors that had previously adopted DB plans have now shut them down to one extent or another. Some employers have terminated their DB plans, while others have closed their DB plans to new entrants. Yet others have frozen accruals under their DB plans for some or all participants. Of late, some DB plans have reduced their liabilities (and their assets) by purchasing annuities (and thereby transferring a portion of their liabilities to insurance companies) or by allowing retired participants to take their benefits as lump-sum cash payments.*

Vine's paper describes legislative efforts to cultivate pension plans, such as enforcing the employee's right to ascertain and verify their benefits, and providing sponsors the freedom to design plans as they see fit, but states that these efforts are colliding with increased regulation and complexity. Yet the paper states that the regulation of DB plans is not the primary reason for the migration from DB to DC plans.

> *If the plan cultivation provisions were fundamentally flawed, one would expect to observe migration away from both DB and DC plans. Nevertheless, during the period from 1985 to 2011, the number of active participants in single-employer DC plans has more than doubled. During the same period, the percentage of Fortune 100 companies offering new hires some form of retirement plan has remained constant at 100 percent.*

> *The differences between DB and DC plans, and between traditional pension plans and hybrid plans, suggest that the migration away from traditional DB plans was attributable primarily to employers' desire to avoid volatile and unpredictable swings in contribution requirements and financial accounting expenses, paired with employers' and employees' preference for plans that allocate benefits more evenly than do traditional DB plans. Although concerns about the burdens imposed by the regulatory provisions of the Code and ERISA appear to have influenced employers' decision-making, particularly with respect to the movement away from DB plans during the past decade, such concerns do not appear to have been the primary cause of the migration away from traditional DB plans in general.*

Are pensions dead?

DB plans are still relevant because they provide stable and secure retirement income for life. As DC plans have become more popular, we have become more aware of their inherent risks: the nature of many participants to make bad investment decisions, the fact that most participants don't start contributing early enough, and the possibility that retirees may outlive their retirement savings.

DB plans are not dead. Not yet, anyway. And I, for one, hope that the pendulum will swing back toward the stability of some form of DB plan because as life expectancy increases, so does the likelihood of outliving your savings. The best solution is likely a combination of DB and DC plans in addition to Social Security. The DC balance could be designed to provide income for a fixed number of years, at which time the DB plan (or "longevity plan") would kick in and provide lifetime income at later ages, while Social Security would provide inflation-adjusted lifetime income. Because DB benefits would be paid over shorter life expectancies, the funding would be much less volatile.

This provides us with the opportunity to do what Bill Halvorson did in 1970. Milliman actuaries are still looking into the future to develop innovative solutions for our clients.

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