September 2013

Milliman

DB digest

Best Practices for Pension Administration

UPCOMING KEY DATES*

10/1/13

Commence IRC Section 436 benefit restrictions if the plan's certified or deemed 2013 AFTAP is less than 80%.

10/15/13

File 2012 Form 5500 using DOL EFAST2, if the due date was extended by a timely filed IRS Form 5558.

10/15/13

File IRS Form 8955-SSA, if the due date was extended by a timely filed IRS Form 5558.

10/15/13

File the PBGC Comprehensive Premium Filing for 2013 and pay flat-rate and estimated (or final) variable-rate premiums.

12/31/13

Deadline to certify the 2013 AFTAP if the plan used a "range" certification.

Why defined benefit plans are still relevant

Richard Pavley, EA, MAAA, MSPA

There is an ongoing concern that the American worker is not or cannot be ready for retirement. In the current investment environment there is no safe, low-risk investment with a sufficient return to allow assets to build up for retirement. Although millions of Americans participate in 401(k) defined contribution (DC) plans, the retirement savings provided by those plans may not be enough.

Few individuals can tolerate a high-risk, high-return portfolio to invest their retirement nest egg, and employer matches wind up sharing this lack of investment return. Many more lack the time necessary to build up a sufficient retirement fund. A recent Frontline episode on PBS ("The Retirement Gamble," April 2013) has people worried that their 401(k) plans will not be able to provide for them in retirement due to the impact of investment fees and their own lack of investment skills. Study after study shows that participants are not able to save sufficiently or are simply expecting to never retire.

How can Americans have retirement security? Maybe the answer has been in front of us all along: defined benefit (DB) plans.

The disappearance of DB plans

If you are under age 35, the chances that you are covered by a DB plan are slim. According to the Employee Benefits Research Institute (EBRI), the number of active participants in DB plans decreased more than 33% between 1980 and 2007 (EBRI Issue Brief, October 2010, No. 348) while DC plan participation has increased 250% over the same time period.

DB plans are retirement plans that provide participants with a steady monthly income once they have reached retirement age. Some plans allow participants to take their benefit in a single "lump" sum, especially if their entire benefit is small. These plans have been around for more than 135 years. The first private plan in the United States was established in 1875 by the American Express Company.

The three most common types of DB plans are flat dollar, average pay, and cash balance.

Flat dollar plans typically have a single dollar amount for each year of service. Often this is adjusted to account for inflation or in negotiations with unions, so it is not always flat, but the formula is still basically the same. Benefits grow with service and are easy to calculate.

Average pay plans usually come in two broad categories: career average and final average pay. The general formula is a percentage of average pay for each year of service. The average can be over a career (career average plans) or highest final "x" years (final average plans), which automatically adjusts for inflation. These plans are sometimes integrated with Social Security because a portion of the Social Security benefit is paid by the employer.

A cash balance plan looks like a DC plan, but the formulas are very similar to career average. The benefit is described as a "notional" account balance, but this balance grows by a formula of pay credits (typically a percentage of current earnings) and interest credits (a pre-defined interest rate applied to the account balance, often linked to a published rate such as Treasury rates). Although tracked individually, the actual account balances are pooled for investment purposes. Participants may more easily understand their benefits as described by a cash balance (e.g., a total value today instead of an annuity at some date in the future).

How do DB plans help participants?

DB plans provide a secure and predictable benefit life, which is safe from market fluctuations. Benefits are typically linked to an employee's service and earnings, and not how much they are willing or able to put aside for the future. Assets are pooled and managed by professionals who are responsible for achieving the maximum investment return for the plan, and ensure there are enough liquid assets (cash and easily marketable securities) to pay expected benefits. The investment risk and mortality risk are borne by the employer, and minimum benefits are insured by the Pension Benefit Guaranty Corporation (PBGC).

How do DB plans help employers?

Employers are always looking for ways to retain long-service employees, and the promise of a secure retirement can be a key to keeping the experienced employees from moving to another employer. A good retirement plan can also be the difference for attracting experienced candidates.

DB plans also help stretch the value of retirement dollars. Numerous studies show that, on average, corporate DB plan investment returns exceed those for DC plans. A study by the National Institute on Retirement Security (*A Better Bang for the Buck*, 2008) stated that DC plans would require an additional 10% of payroll to match the economic effectiveness of DB plans. This is not only due to the pooled investments mentioned above, but also to the pooling of longevity risk (the risk of outliving one's assets). The amount of employer money necessary to provide the same level of retirement benefit is less for DB plans in the long run.

What's this about longevity risk?

The recent improvements in life expectancy have created a new fear: outliving our savings. How do we protect ourselves from this new threat? Longevity plans, providing security against outliving one's assets, are a recent concept put forth in the Milliman white paper *Longevity Plan* by D. Quant, Z. Wadia, and D. Theodore (February 2013). They propose tackling this risk by providing a DB plan that begins to pay out benefits only to those who live beyond a typical life expectancy. Pooling the risk and simplifying plan design (no disability options, no early retirement benefit, and limited death benefits) would decrease costs and improve funding predictability.

What about portability?

Employees in the Internet economy seem to move from employer to employer as rapidly as they move from project to project. DC plans have built-in portability, as the growth of the account balance does not change based on employment, only on investment elections. These plans provide terminating participants the opportunity to roll over their accounts to individual retirement accounts (IRAs) or the accounts of their new employers.

DB plans have approached portability in a number of ways.

First, small benefits can be cashed out and rolled over into an IRA or other qualified plan. Small benefits are usually defined as lump-sum value under $5,000. Some plans provide for a higher threshold, and some plans use a lower one. However, the result is the same: Participants receiving lump sums can move their benefits along with them.

Second, cash balance plans typically allow the rollover of the account balance to an IRA. Along with defining the benefit as a single sum, many plans also allow rollovers upon termination of employment.

Finally, in at least one area, DB plans have tackled portability from the earliest days: multiemployer pension plans.

A multiemployer plan, as the name implies, is a single plan administered by more than one employer. These plans typically cover workers in a single industry such as trucking, manufacturing, or entertainment, and allow workers to move from one company to another while remaining in the same pension plan. Many of the employers are small companies, and the participants are members of a union. This allows drivers or carpenters to move from job to job without worrying about their benefit plans.

Any or all of these approaches will provide portability of benefits.

If DB plans are so great, what happened to them?

There are two reasons why DB plans have been viewed less favorably than DC plans. First is the nature of the funding and accounting requirements: When investments under-perform and employers are least able to fund benefits, the required contributions are highest. Also, when interest rates are low, liabilities are high, with rules that require basing a liability that may last 50 years into the future on current market events.

These situations cause volatility that makes it difficult for employers to make reasonable business plans, especially when the pension liability may directly affect the corporate balance sheet.

However, this volatility could be constrained by working with plan actuaries and investment consultants to develop funding policies and strategies designed to reduce volatility.

Relevant: Having significant bearing on the matter at hand

If the goal is to provide employees with a secure retirement, DB plans are still relevant. Through the combination of pooled investment by experts, mitigating longevity risk, and the potential for the same portability as 401(k) plans, DB plans can still be a key part of today's retirement plan landscape.

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