Corporate Defined Benefit Plans at a Crossroads

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Corporate America’s defined benefit retirement plans are at a crossroads. Announcements of plan terminations in connection with bankruptcies are increasing, as are benefit freezes by financially healthy plans. While today 34% of Americans over age 65 are drawing a lifetime income from a defined benefit plan, the next generation of corporate retirees is unlikely to be so lucky. By 2003, among the roughly half of workers with retirement plan coverage, the percentage covered by a defined benefit plan had fallen to 38%, down from 80% in 1981. Those covered only by a defined benefit plan fell from 57% to 10% in the same period, in part due to the rapid growth in defined contribution plans.

If more terminations and freezes occur, even those who still have defined benefit plans will likely find themselves increasingly dependent on defined contribution plan savings to make ends meet in retirement. The result of a dramatic confluence of several major factors, this trend is unlikely to reverse anytime soon.

The factor accelerating the trend the most has been the behavior of investment markets since the beginning of the decade. A combination of poor returns early in the decade and a decline in long-term interest rates has dramatically raised the demands on corporations to fund their plans with cash, the result of simultaneously lowering expected returns on assets while increasing the present value of plan liabilities.

Consequently, as illustrated in Exhibit 1, we have seen an explosion of corporate cash contributed to defined benefit plans following more than a decade in which many plans had such strong returns as to require almost no funding at all. Accordingly, what previously had been a human resources question about the right retirement plan for employees has been transformed into a matter of high-level corporate financial policy, with efforts to find alternatives widespread.

As a result, companies in many industries have concluded that the traditional defined benefit plan is simply no longer
affordable, at least not in its current construction, where the plan sponsor underwrites both investment returns and mortality risks.¹ In the increasingly global economy, many companies face competitors that do not have such plans and the costs and risks they involve.

In this context, one can easily conclude that defined benefit plans are an anachronism that should be replaced by a defined contribution plan, widely seen as a benefit plan with a more predictable impact on corporate financial results and greater flexibility to manage costs. This transformation allows a company to transfer the investment and mortality risk to their employees, similar to the way many companies have transferred more of the risks and costs of health care to their employees over the past decade.

In view of the heightened attention being paid to the financial policy implications of providing a defined benefit plan, the mark-to-market accounting that regulators and accounting authorities are pressing for will only intensify the pressure to revisit the rationale for them. No later than 2007, actuarial smoothing of investment results will no longer be available and changes in the funded status of a corporate plan will be much more visible. To understand the implications, Exhibit 2 presents corporate retirement expense as a percentage of payroll under current accounting standards and without the smoothing they permit, assuming that future investment experience is comparable to that of the 20 years that ended 1993.

While initially this newly volatile expense will be recorded in other comprehensive income rather than net income, Phase II of the FASB’s program for the review of pension accounting includes plans that are likely to make this volatility more visible in future years. In addition, the pending federal legislation’s provisions regarding funding will also eliminate some smoothing options from the calculation of required cash contributions by sponsors.

Exhibit 2: Accounting Challenges: Potential Impact of Marking to Market

³Note that the question of efficiency has been lost in the discussion about costs. In general, there is little doubt that there are far fewer administrative expenses in defined benefit plans per dollar paid to employees, and considerable evidence to suggest that they consistently earn better investment results than defined contribution plans. However, the cost that corporate sponsors are concerned about is their own cost, which can be lessened by requiring that employees contribute to retirement plans themselves. Defined contribution plan costs are also more easily predicted and controlled by their sponsors, who can take funding holidays in tough financial periods. The confusion over what is meant when defined contribution plans are said to cost less is only further compounded by accounting, as it is typically the effects on near term corporate accounting results that are cited as evidence of savings from the freezing of defined benefit plans.
In these circumstances, many chief financial officers who have not already reviewed the impact of continuing a defined benefit plan will most likely do so during the course of 2006. While not every firm will conclude that a freeze or a termination is feasible or appropriate, many more will act than have so far. In all likelihood, the final shape of the pension reform bill will be a further catalyst for decision-making in many of the corporations that still sponsor defined benefit plans.

THE IMPLICATIONS FOR INVESTMENT MANAGEMENT
Much has been written about the need to adapt retirement plan investment practices to a world in which liabilities become the most important benchmark. The performance of corporate plans has always been measured against investment benchmarks and against peers, as well as against their liabilities, but the experience of the early part of the decade has convinced many firms that performance against liabilities will be paramount in the future. Specifically, their argument is that investment performance will need to track changes in the value of liabilities much more closely.

The strategies that have been promoted to achieve this can all be referred to as liability-driven investing, but there is a wide array of ideas gaining favor among corporate plan sponsors that are being justified on these grounds. The matching of assets with liabilities is a form of investing familiar to life insurance portfolios and leads to heavy use of fixed income assets with a relatively long duration in corporate defined benefit plans. In the extreme expression of asset/liability matching, liabilities are simply annuitized – either by a defeasance or by the hiring of an insurance company to take over the payments. Effectively, risk tolerance is limited by the requirement to minimize tracking error versus liability valuation.

In the United Kingdom, mark-to-market pension accounting has led to significant increases in the use of fixed income instruments to fund pension liabilities, to the point where increased demand for long duration bonds has distorted the U.K. yield curve. The principal impediment to more widespread adoption of this approach in the U.S. has been the current, historically low level of rates, making the costs associated with this strategy very high. A few U.K. corporations found themselves embarrassed by the poor performance of their plan relative to those of other U.K. companies after going to an all-bond portfolio and have subsequently moderated their approach. Comparison to peers and benchmarks is not completely dead as an influence on corporate behavior, and enthusiasm for full matching of assets to liabilities will probably increase only as it becomes generally accepted practice, which in turn will probably not happen unless long-term interest rates rise significantly.

Instead, U.S. corporate plans are more interested in investment programs that allow for consistent returns higher than those available in the current fixed income markets, combined with derivative-based hedging of their plan liabilities. It is this search for a different route to consistent returns that has powered much of the interest in hedge funds and given new impetus to the demand for core real estate investing. It is also the primary motivation for the search for ways to separate alpha and beta, which promises both cheaper exposure to beta and more consistent levels of alpha. Hedging these results back to a spread over changes in the value of plan liabilities is achieved by hedging with derivatives, either done in-house or outsourced to investment banks or investment managers.

Obviously, investment managers have responded to these demands and will continue to do so. Investment banks, with their large derivatives trading operations, are more frequently in the mix as well, often pitching these ideas to the financial staffs of corporate plan sponsors. How this will all sort out is very much an open question at this point, but it is clear that the investment practices of corporate and public defined benefit plans are diverging, with government plans having little or no pressure to react to the accounting issues that are increasingly preoccupying their ERISA counterparts.

THE IMPLICATIONS FOR CORPORATE POLICY
While this may not be the way some corporate executives think about these issues, withdrawing defined benefit plans will transfer two significant risks to employees, investment risk and mortality risk. To understand the investment risk,
consider that two employees separated by two years in age can each save identical amounts of money in their defined contribution plan and invest in exactly the same asset classes, yet face retirement with vastly different outlooks if they each retire at the same age but two years apart. The employee who retired in 2000, for example, would face a much more favorable prospect than one who retired in 2002, because the 2000 retiree, having enjoyed better market performance as of his retirement date, would have accumulated a much larger asset base. In contrast, in a defined benefit plan, the plan would pay each an identical lifetime rate of pay.

The transfer of investment risk created by the withdrawal of a defined benefit plan is obvious enough. The defined benefit plan pools the investment risk and allows each of our two hypothetical employees to enjoy the same expected benefit payments, regardless of market conditions in the year of retirement. A defined contribution plan provides for the setting aside of a certain amount of money, with no guarantee as to the amount of income that money will purchase. These plans also transfer asset allocation and rebalancing decisions to many who are unprepared to discharge this responsibility thoughtfully. (To illustrate this point, consider that almost half of all defined contribution plan participants never change their asset allocation from their initial decision.)

The transfer of mortality risk is no less significant, but its implications are more subtle and less fully understood. In a defined benefit plan, early deaths help pay for the plan’s benefits. To the extent they think about it, participants regard this as natural and understandable, since the plan is clearly understood as a promise to pay certain amounts for so long as the beneficiary (and other beneficiaries) live and because plan participants do not actually see a pool of money that they identify as belonging to them. When mortality risk is no longer pooled, there are feedback effects on investment approaches that are poorly understood by almost everyone, because an investment approach that makes sense for a group ceases to be meaningful for an individual.

In fact, the very nature of the asset allocation question differs between an individual and a group. Monte Carlo simulation makes it clear that the key to success for individuals (and the key to minimizing the severity of failure when it occurs) is more complex than just setting the mix of equities, bonds, and alternatives. This is quite unlike the experience of a defined benefit plan, where such asset allocation questions are the primary driver of success or failure. Individual portfolios are not best thought of as miniature versions of institutional plans, and their asset allocation issues are different in kind, not just in degree.

The additional asset allocation issue that must be considered by an individual is the right mix of lifetime guaranteed income vehicles (“annuities” in its most generic sense) versus all other investments. While the answer depends on the ratio of an individual’s wealth to his or her needs, for most people the share of spending that can be funded by sources of income guaranteed to last for life is extremely important to the odds of success, and to minimizing the severity of any failure that may occur. This is unsurprising. It is this critical need to manage mortality risk for the individual, rather than for a group, that drives the difference in asset allocation priorities. The reason for this is straightforward — outliving one’s savings, especially if the risks of inflation and health care are factored in, is the greatest additional risk that most retirees must now manage for themselves in light of the decline of the defined benefit plan.

Unfortunately, individuals are extremely reluctant to annuitize their assets at retirement — or otherwise, for that matter. There are several reasons for this. First among them is the reluctance to pool mortality with one’s own money. Obviously, a traditional annuity does not pay past the death of the annuitant(s). This principle is perfectly well accepted in a defined benefit plan or Social Security, which are also forms of annuity. But, if they die an untimely death after actually parting with cash to purchase an annuity, people expect to get their money back for their estate. While this desire can be accommodated by adding life insurance features

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1 Source: Corporate Executive Services Roundtable 2002.

2 The commentary in this section about the results of Monte Carlo modeling of individual investment risks in retirement is based on work performed by Ernst & Young at the direction of Prudential. A fuller account of the analysis will be published in a forthcoming white paper.

3 To further complicate the individual asset allocation modeling exercise, the optimal mix of assets can depend on the degree to which annuities cover anticipated retirement expenses for many people. Oversimplifying, the greater the confidence that one’s retirement income will suffice, the more useful it is to take market risks in the accompanying investment portfolio. Hence it seems clear that the first asset allocation question an individual must assess is the proportion of assets to invest in guaranteed income vehicles, followed by consideration of the appropriate portfolio mix for the remaining assets.
to an annuity purchase, which happens in over 80% of all variable annuity purchases today, the cost and complexity of the annuity are both increased as a result.

The second major obstacle to annuitization has been the loss of control over investment assets that it entails. When an insurer takes individual annuity risk, it has traditionally entailed surrender of assets to the insurer, which in turn is obligated by regulation and risk to tightly match the investment of those assets with the associated liabilities. Once again, the cost of that approach is an issue because of today’s low interest rate environment. Even more importantly, however, the surrender of control over investments runs contrary to the psychology of too many U.S. investors, particularly of the Baby Boom generation, who have been educated by most financial institutions to retain as much personal responsibility and control over investing as they can. A recent LIMRA study indicated that fewer than 10% of households would consider annuitizing more than half their assets. As further evidence of this reluctance, consider that fewer than 2% of all individual annuities purchased today ever actually annuitize, the rest being cashed in for their value.

Finally, there is the objection to the cost of annuitization. In a low interest rate environment, annuitization can be an expensive proposition. But, too often, the costs of annuities have been unfavorably compared to the costs of other investment vehicles that do not offer the payment of a lifetime income. This is not a fair comparison because an annuity provides something of vital importance – a lifetime payment guarantee – that other pooled vehicles do not offer. But, fair or not, such comparisons of costs represent another obstacle to annuitization.

To return to the initial discussion of corporate policy, those corporate executives who decide to freeze or terminate defined benefit plans may not fully recognize or appreciate the transfer of investment and mortality risk that follows. In general, most employees are not well equipped to deal with the consequences. What can a corporate plan sponsor do to mitigate the effects? The best place to start is with improvements to the features of their defined contribution plans, in order to get them closer to delivering the more desirable features of defined benefit plans.

**DEFINED CONTRIBUTION PLAN DESIGN**

Several ideas along these lines have increasingly become part of “best practices.” For example, it is important to establish so-called “autopilot” provisions that increase the likelihood that employees will participate in a defined contribution plan, establishing enrollment as the default option for employees. Similarly, well-designed investment defaults, coupled with programs and company-match structures that encourage greater savings, are promising strategies for defined contribution plan participants. Such solutions have garnered widespread support among corporations and members of Congress. Hopefully, the final version of the pending federal pension reform legislation will include provisions to facilitate such outcomes by pre-empting state laws that today inhibit automatic enrollment and by clarifying that providing such features does not increase the fiduciary risk of the plan sponsor.

**DEFINED CONTRIBUTION PLAN INVESTMENT MANAGEMENT**

Likewise, it is important to work to improve the investment results of defined contribution plan participants. A change in current law that would permit expert advice to be more freely provided without fiduciary jeopardy should lead to more widespread adoption of this practice. While a defined contribution plan may be less efficient than a defined benefit plan, investment results should be improved by making available to retirement plan participants the same advice that is routinely available to retail investors.

**LIFETIME INCOME SOLUTIONS**

Some well-intentioned defined contribution plan sponsors have begun to offer annuitization options at retirement. There is debate in Washington about whether there should be legal incentives or mandates to encourage others to follow suit. Unfortunately, the experience of the early pioneers in offering annuitization at retirement is not encouraging, as few retirees annuitize even when the process is simplified and the costs are mitigated by the plan sponsor’s efforts.

There is a solution to this problem. The annuity industry has had considerable recent success in overcoming the obstacles to annuitization cited above by adding so-called
guaranteed lifetime withdrawal benefits to traditional annuities. Instead of requiring immediate annuitization and transfer of assets, these features generally allow investors to select from a range of investment options and to initiate a guaranteed stream of payments at a point of their own choosing. At that time, the insurer provides a floor guarantee of the investment result for the life of the contract holder, while leaving them free to exercise choice among investment options and to benefit from any investment performance that exceeds the floor. Adoption of parallel features in defined contribution plans may lead to more widespread election of lifetime annuities. They would allow plan participants to retain control over their investment assets and provide the opportunity to participate in investment performance while still putting a lifetime income program in effect. In addition, it may be of interest to those operating cash balance defined benefit plans, as a way to enhance employee satisfaction with such plans.

DEFINED BENEFIT PLAN DESIGN
We cannot discount the odds that increasing numbers of plan sponsors may simply wish to eliminate their ongoing responsibility for traditional defined benefit plans. Some may wish to modify them to limit their volatility and cost. Others may convert them to trusteed plans if that route can be structured to offer them a better accounting outcome. Others may wish to write a one-time check to transfer the assets and liabilities to an insurer. Still others may look for hybrid solutions, transferring a “stop-loss” risk above a first loss position. The different permutations are hard to anticipate fully at this point.

However, there can be no doubt that the future of the corporate defined benefit plan is at risk and highly unpredictable. It will take a combination of investment skills, actuarial analysis, and balance sheet capacity, not to mention some luck and the passage of time, to fully address the range of possible outcomes.
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