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THE LIFE OF THE DEFINED BENEFIT ACTUARY AFTER THE DEATH OF THE DEFINED BENEFIT PLAN

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- o What is the current expected mortality rate of defined benefit plans?
- o What changes in this mortality rate is the future likely to bring?
- o Will defined benefit plans be replaced by other programs requiring actuarial expertise?
- o Will retraining of actuaries be necessary?
- o What can we learn from other places, other times?

MR. SILVIO INGUI: Before the passage of the Employee Retirement Income Security Act of 1974 (ERISA), the laws and regulations that governed retirement plans were not as complex, nor did they impose as significant a burden on sponsors and administrators of pension plans. Some of the changes that ERISA introduced are as follows:

1. Specific requirements for disclosure and reporting were mandated, not only to government agencies, but also to plan participants. For the first time, employers were faced with the task of having to furnish to plan participants explanations of plan benefits that conformed to legislative requirements (i.e., Summary Plan Descriptions, notices to participants when they left, and so on).

2. ERISA also introduced minimum funding standards. Pension plans were now required to fund specific amounts, as determined by the plan actuary, which met best-estimate requirements. These minimum funding standards eliminated much of the funding flexibility that employers had and resulted in greater contributions.

3. The third significant change that ERISA made was the establishment of the Pension Benefit Guaranty Corporation (PBGC). Employers sponsoring defined benefit plans were required to pay premiums to insure certain benefits for plan participants. Even more significant was the requirement that employers which had defined benefit plans with unfunded vested liabilities would be held

responsible, in the event of plan termination, for the portion of the unfunded vested liability that did not exceed 30 percent of the employers' net worth.

All of this has led to higher costs for plan administrators and plan sponsors and potential liabilities to companies in the event of plan terminations. Therefore, employers began looking to other alternatives, and one such alternative is the defined contribution plan. Thus, since the passage of ERISA, there has been a trend toward companies adopting defined contribution plans.

When I speak of defined contribution plans, I refer to a group of plans which includes money-purchase plans, profit-sharing plans, thrift-savings plans, 401(k) plans, and employee stock ownership plans, payroll stock ownership plans, and simplified employee pensions. However, defined contribution plans do not solve all of the problems that are associated with defined benefit plans. In some ways they solve the three major problems, in that they are simpler (for employers to explain and for employees to understand); there are no minimum funding standards (with the exception of money-purchase plans); under a typical profit-sharing plan, the employer has the flexibility to contribute less during poor years and more in good years; and defined contribution plans are not subject to PBGC liabilities or premiums. (In the beginning, these premiums were not considered too onerous to the employer, but the legislation that is before us may significantly increase that premium to the point that it becomes a burden to some employers.)

Although defined contribution plans solve some problems, they have several shortcomings of their own which prevent them from meeting the retirement needs of all classes of plan participants. These include:

1. There is no guarantee of the benefits that will ultimately be provided to the employees.

2. Retroactive changes and past service credits for new plans cannot be effectively implemented.

3. Older employees cannot accumulate sufficient account balances to provide adequate retirement income.

4. Profit sharing plans do not guarantee that any contributions will be made or that sufficient contributions will be made to provide an adequate retirement income.

5. Poor investment selections on the part of the plan sponsor or plan participant (where the participant has the right to direct the investment of contributions) could result in inadequate account balances and, hence, inadequate retirement benefits for the employee.

6. Defined contribution plans generally have lump-sum options. Thus, there is a greater temptation on the part of participants to take a lump sum, which does not always ensure that the

participant will manage the funds appropriately to provide a lifetime income.

Therefore, because of these reasons, I do not believe that the defined benefit plan will become extinct. In fact, much of the current proposed legislation is attacking defined contribution plans which are perceived by some of our legislators not as retirement plans, but as capital accumulation plans. This proposed legislation is trying to encourage defined contribution plans to provide some sort of retirement income feature.

Thus, when we address the issue of the expected mortality of defined benefit plans, I do not believe that the picture is as bleak as some people may say it is. I believe that defined benefit plans have endured and will continue to endure; however, there has been a change in the ways employers are viewing their retirement programs. All of us have heard of the three-legged stool; that is, that the retirement needs of an individual should come from three sources--private retirement plans, Social Security, and personal savings. With the passage of the Social Security Act of 1978, we saw a change in the direction of Social Security benefit levels. For the first time, legislation was passed that actually decreased anticipated future Social Security benefits. Also, during the 1970s, this country experienced a period during which employee savings decreased. It therefore was left to the employer to attempt to fill the void that reduced Social Security benefits and reduced individual savings were creating.

One way to do this would be to increase benefits under pension plans. Although this is a simple solution to the problem, it could also be a costly solution. Another solution, which was more attractive to employers, was to encourage employees to increase the level of their savings, so that the third leg of the stool would play a more important role in meeting the employees' retirement needs.

Companies began to discover that one program does not always meet all objectives, and that a combination of plans, one a defined benefit plan and the other a form of defined contribution plan, provided the best retirement program. Many of the defined contribution plans that have been implemented in recent years were not to replace terminated defined benefit plans but instead were to supplement them. They represent an efficient way for employers to fill the void created by lower Social Security benefits and the lack of incentives for employees to save.

Employers realized that, given the proper vehicle, employees would systematically set money aside for retirement. Before IRAs and 401(k), employers began to implement profit-sharing plans to supplement the company's defined benefit plan. Many of these encouraged voluntary employee contributions which could accumulate on a tax-deferred basis. Many of these plans were of the thrift-savings nature, where employees were encouraged to contribute in order to have an employer match. Finally, the passage of Section 401(k) of the Code enhanced the use of a defined contribution plan to supplement a defined benefit plan.

MR. PETER G. GRANT: We are talking about the life of the defined benefit actuary, which is a narrow definition. It sounds like the definition of an expert, who is someone who knows more and more about less and less until he knows almost everything about practically nothing. I hope that is not the direction we will be taking our profession.

Let's think back to something that has happened within the near-term lifetime of everybody here. One of America's most well-managed companies in the early 1970s, which made a product that was almost universally used--you couldn't build anything without their product--is now out of business, because it didn't look forward enough to see that small hand-held electronic calculators were going to replace slide-rules. It had a monopoly on a product which is no longer useful. The problem this raises is why didn't that company see that coming? The Society's Futurism Section should perhaps address the future work that actuaries are going to do if anything of that type comes along.

Mr. Ingui has set the stage well for this presentation, and I think he has reached the conclusion that each of us would have reached, namely, that the demise of the defined benefit plan has been greatly exaggerated. I think that it is going to continue, but it may continue in a much diminished role; there may be a lot of smaller employers that may not be so willing to make the commitments that defined benefit plans demand, so we may be faced with a universe in which there are fewer defined benefit plans sponsored only by larger employers.

There are other threats to the work we do as defined benefit actuaries. What if the Financial Accounting Standards Board decides to prescribe assumptions as well as methods? What if some nefarious firm decides that it can build a black box that will handle all such calculations, thereby significantly reducing in nature the work that many of us, and the people we direct, do in our occupation?

One of the first thoughts I had was that a defined benefit actuary is, after all, an actuary. We can go back and do all of the things that all other actuaries do. On the other hand, those other actuaries are already doing those things, and they might not be willing and charitable enough to give up some of their work for us. So, perhaps we do have a bigger problem than it first appears.

Focusing fairly narrowly on a set of subjects that might be appropriate work for someone who has extended his expertise and trained himself down into the defined benefit area, I would like to address just that small segment of the ultimate potential work that actuaries can foresee.

1. There is an intriguing defined contribution plan called a target benefit plan, which is a plan where contributions are established by age and can actually be established by service as well, to replicate the benefit levels found in defined benefit plans at retirement. The beautiful thing about these plans is that they require an actuary to set the rates, because you have to set the contribution rates appropriately; these rates have to be reset every two or three years depending on investment experience; and so on.

So, target benefit plans are a good area within defined contribution plans where actuarial expertise is required. Unfortunately, you don't have to reset the rates that often, since we can be reasonably good in our projections, and by doing too good a job, we can put ourselves out of work. So that won't totally replace any diminishment of work by defined benefit actuaries.

2. Defined contribution plans have a lot of limitations, particularly in the areas of providing benefits to people with short service and providing early retirement benefits. For small groups of senior executives or small groups of employees, ERISA allows an employee to have a supplemental plan. Interestingly enough, ERISA does not describe how small a "small" group is; I have seen small groups ranging up to hundreds of people in large corporations. So, maybe there are opportunities here in the field of supplemental benefit plans.

   These plans take us right back to the days before ERISA, because they do not require vesting and so on. The trouble with supplemental plans is that there just wouldn't be enough work to go around; before ERISA came along, actuaries didn't have nearly the volume of work that we do now.

3. Probably the single best source of new business for our group is a brand new type of defined benefit plan. How about a plan that promises $75 to $90 a month, regardless of service, fully vested, indexed at a rate about 2 percent above the cost of living? Think we could get an employer to buy such a plan? Should he fund it? Should he expense it? Well, he's not! What I've described is what U.S. employers are now providing in the form of post-retirement medical coverage. Those plans are not being funded; they are not being expensed; and they are not having the actuarial expertise applied to them that needs to be.

   I think that there is almost no likelihood that Congress is not going to take some action in this area; I think we are going to see some action in the area of participation requirements, vesting requirements, and maybe even accrual requirements, since the latter two go almost hand-in-hand. It's going to set up a whole new structure of work for actuaries who are skilled in the defined benefit area. These are tougher calculations than we are used to, since you now have to deal with the area of postretirement medical inflation and also the presumed continuation of Medicare and its influence on the plans. There is an enormous amount of opportunity in this area, and there will be a lot of work in the future.

   One of the first things we have to do with these programs is jump in with both feet, and get involved with the design of these programs. If there are any defined benefit actuaries who are most at risk, it is the group that concentrates primarily on the numeric side of the work and doesn't get involved with the design issues of defined benefit plans.

4. While defined benefit plans are not going to disappear, the techniques we use with such plans will have to change. The whole issue of calendar year assumptions, for example, leads to a more complex discussion with a client and a more complicated analysis of experience during the past year.

5. In predicting future interest rates, the suggestion is often made that consultation with an economist should be used. Why have we let the economists take away part of our work? How have we let another group make such projections based on past trends, when that is one of our stocks-in-trade? We must be more assertive in establishing ourselves as experts in that area. If it was an actuary on whose predictions the stock market rose or fell, we would no longer have our identify problem.

6. Along these lines, we may need changes in the syllabus addressing more economic and investment theory. The whole issue of modern portfolio theory and its derivatives is much more a mathematical means of investing funds than has been used in the past. That should in turn open up the entire asset investment side of the pension equation, which is an area we have sadly neglected in our dealings with corporate plan sponsors. Actuaries in the U.S. and Canada have not focused on this issue to the extent that actuaries in the United Kingdom have, for example.

7. We have been negligent also in the areas of discounted cash-flow analysis and the time value of money, areas in which the accountants are currently touting their expertise. We had better not allow our knowledge of the interaction of probabilities on future events, and the resultant increased meaning of discounted cash flow techniques, to become the tools of another profession.

MR. CHARLES BARRY H. WATSON: I have been informed that a Society committee has, indeed, been working on some of the problems addressed herein. It ran a Delphi-type investigation into future employment opportunities for defined benefit plan actuaries. A sample of about 20 actuaries was asked whether they would expect in the future to be working in the same areas, on other pension matters, on other nonpension actuarial matters, or on none of the above. Concern was expressed by the panel about the monetary awards (whether earnings would increase, remain level, or decrease) and job satisfaction in the future.

The results of this study were analyzed, with the tabulation of results carried out by a young actuary with extensive computer experience. The initial computer results showed percentage responses in excess of 100 percent for some answers, with standard deviations approaching 200 percent! These results were never reviewed by the actuary for reasonableness, as the actuary presumed computer application removed his responsibility for independent judgment.

The lack of judgment is a key point; I believe that the actuary who believes that is primarily involved in using his judgment, whether or not actuarial, will not have to worry about future employment, with

respect to opportunities, remuneration, or job enjoyment. The people who have to worry are the straight technicians, the backroom people, who could possibly face employment problems in the event of an endangerment, if not the death, of defined benefit plans. Those who use judgment will still be needed in the areas of design, alternatives, and so on even in the event of a curtailment in the amount of actual calculations that may be needed. Those who forget the importance of our judgment, and the areas that require applications of such judgment, will have problems.

If retraining or reeducation of actuarial matters is required, I believe that such retraining will concentrate on the applications of actuarial science, not the theories and principles upon which the profession is built. We are, after all, professionals who are practicing a science, not merely laborers carrying on a craft or a trade; as long as we remember that it is our science and our principles that we bring to our profession, we will be all right.

I would like to deal with a few items pertaining to overseas matters. Fundamentally, the situation is fairly similar to that of the United States; we see in all the developed countries the burgeoning of regulations which, for better or worse, seem to hit harder on defined benefit plans than on other types of plans. That is probably because defined benefit plans are generally more complex, leading to constraints, requirements to report, and so on.

While there is little that can be done to avoid regulation, there are other areas where our expertise may be applied. For example, the problems of funding--how to ensure that enough money is available to pay all benefits without contributing too much--become more important with uncertain economic situations. The problems that we used to see in foreign countries, including extreme rates of inflation, wild fluctuation in interest rates, and productivity swings, have appeared here in the past ten years, and both we and plan sponsors now realize that those problems are not limited to other countries. We have to be willing and able to assist sponsors in determining how to fund these plans intelligently and responsibly.

A related problem is that the liability of the sponsor of a defined benefit plan is uncertain; the funds needed next year are unknown, much less those needed 20 years into the future. We can address this problem through projections of outlays, projections of contributions, and more, based on various economic scenarios, and surely if there is anybody who can help an employer deal with this situation, it is the actuary.

I am optimistic about the future of the defined benefit plan because, if you look at the experience of countries around the world, you see that nearly every developed country ends up with an innate desire for some sort of defined benefit plan. You could almost describe it as a hallmark of development. It is in the undeveloped countries where the retirement programs seem to be just money thrown into pots, while, in the more developed countries of Europe, you find the extensive use of defined benefit plans. Whether it is greed, or the desire to better

know what the benefits will be at retirement, human beings seem to want defined benefit plans.

If, however, there may be somewhat less work in the future with defined benefit plans, we should address other alternatives. Work for the government does not seem to be the answer, for in some countries the governments appear to be trying to take over all the defined benefit arrangements, to break off the one leg of the stool and merge it with the social pension leg. In India, the government took over all the insurance companies, and Great Britain, Australia, Canada, and New Zealand, ended up with some good Indian actuaries!

In the area of defined benefit plans, we are going to see more complex benefits, more concern about survivor options and inflation protection, and more projections. In addition, we will see more of a role for an actuarial ombudsman in defined benefit plans. By that I mean that actuaries are not paying sufficient attention to the ERISA requirement that the actuary's responsibility is essentially to the plan participants and that, some years down the road, there will be a new breed of Enrolled Actuary who follows this requirement to the letter.

In the area of defined contribution plans, several points have already been addressed. In addition to those, the use of employee contributions may become more prevalent, requiring additional expertise in plan design, investment options, and conversions to benefits.

Still another area where benefit actuaries will find employment is the prefunding of other types of benefits, including not only retiree medical, but also preretirement health, life insurance, and casualty-type benefits--all those areas which provide for a future outlay of funds that could be funded in advance on, perhaps, a tax-deductible basis. This leads immediately to the concept of flexible benefit plans and the actuarial opportunities that exist therein.

There will be opportunities in other areas, such as health maintenance organizations and preferred benefit options. Options will exist for individuals to apply their benefit monies in different ways.

We may end up with more actuaries working for major employers.

Investment opportunities will continue to be available; for example, stock performance in the United Kingdom is defined not by the Dow-Jones Indexes but by the Actuaries Index. The belief in this country that actuaries are not knowledgeable about investment matters is to my mind a scandal, and we will have to address this. We are uniquely qualified to do financial planning in any area that involves human contingencies, and even other types of risk. The biography of a distinguished actuary in Great Britain detailed how he spent his entire career working for the London Transit Board, figuring out the distribution and populations of transit systems.

To close, I believe that the defined benefit plan is only in danger, not dead. Even if the defined benefit plan were to die, there is no need

for the defined benefit actuary to follow it by committing suicide. We have to consider our opportunities, not our problems.

MR. THOMAS M. MALLOY: I have one addition to the litany of opportunities that are out there in the future, especially in light of the time-bomb represented by defined contribution plans. There is little awareness on the part of operations that have shifted to defined contribution plans of the inability of such plans to deliver a stable, predictable, sufficient retirement benefit, and some time in the future, we are going to find employment bailing out those programs and advising sponsors on how they can get back on track delivering benefits considered to be an appropriate percentage of final income. The major airlines had a glorious experiment with the variable annuity, beginning in the 1950s, which was going to solve the problems of inflation losses. In the 1970s, when inflation began to assert itself, one-by-one all of those programs folded. Individual retirees who terminated in 1973-74 with 50 percent of their benefits tied up in these annuities have still not climbed out of the hole they found themselves in.

MR. DONALD S. GRUBBS, JR.: Even more disastrous than the variable annuity was the decline in sales on books on that topic written by actuaries! Perhaps more important than the distinction between defined benefit plans and defined contribution plans is the distinction between plans that provide retirement benefits and those which are savings vehicles. We are going to get legislation in the near future which will discourage the use of retirement plans for savings vehicles, which will do away with the favorable treatment of lump-sum distributions by either the ten-year averaging or capital gains treatment and will provide penalties for early withdrawals, with perhaps extra penalties for withdrawals in a particular year that exceed given levels. With those kinds of changes, we are going to see a decline in the popularity of defined contribution plans, which itself will be a stimulus to defined benefit plans.

MR. CHARLES WALLS: We have seen a steady parade of government people out to the heartland of the country carrying this message. Every government speaker I have heard recently has said that the government wants each pensioner covered under a private arrangement to have a monthly check arriving at the same time as the Social Security check, and they are rethinking their position of driving defined benefit plans out of existence.

One question I had deals with actuaries in other disciplines--how some of us got that way and what we might do about it. Regarding economists, I suspect that the fact they have both university and government bases to which they can go has led them to be able to do things for reimbursement that actuaries cannot.

MR. GRANT: I agree with you. I believe that this is an opportunity and a challenge for us, and we probably ought to take our educational process in this direction to a more thorough degree. We have given up some of our turf to other professions, and we should consider reclaiming it.

MR. WATSON: My personal belief is that actuaries are just not taken seriously as scientists by most people in government, universities, or industry. One reason for this is that we tend to be viewed as being in thrall to the insurance industry; many people believe that, no matter what we say as we consult, we are basically the hand-maidens of the insurance industry. Thus we are not seen as scientists but as technicians.

MR. RALPH E. EDWARDS: The point has been made that actuaries are not taken seriously, but we should not make the mistake of being viewed by the public in the same vein as most economists are. I would like to suggest that Mr. Watson's worries about representing the interest of the participants in a defined benefit plan is a function of the law, which says you represent the participant, but then defines carefully what the actuary's duties are, and then restricts them so that no vehicle exists to go to the participants. The Academy acts as our legislative interface, but what we interface is not what is involved in our communications with participants; rather, it puts an actuarial footing under what other people handle.

There is a conflict between what we do in pensions on behalf of the participants and our addressing Congress when they ignore certain principles by establishing indefinite philosophical standards that may work against plan participants. For example, the limits imposed by the government on defined benefit payouts to top executives may remove any incentives an executive may have to allow the plan to work beyond that limit for him. This lack of incentive to improve the plan may end up affecting all plan participants, and we have no way of presenting that to Congress in our official capacity; instead, we can only act as individuals through our own Congressman.

MR. WATSON: I am concerned that the public will believe that we as Enrolled Actuaries have certain responsibilities and powers that we, in fact, do not have. Hence, we may be accused of not doing what we are supposed to do, and therefore, we may end up with a bad reputation. Does anyone have comments regarding my reference to an actuarial ombudsman?

MR. GRANT: I believe that it is a role that we are going to have to play. One of the remarks that I have heard several times is that we are eventually going to see a lawsuit against an actuary regarding the level of funding of a plan. Because of the provisions of the law, we must play that role in the future.

MR. INGUI: As actuaries, we deal with a subject that is complicated to other people, who cannot comprehend what we do, and it is part of our role to educate other people on what we do, to let Congress understand that laws to close deficits should not be made without considering the effects of such legislation on people's benefits. We must educate the populace and our legislators on the importance of actuarial work relative to employee benefits.

MR. COLIN B. ENGLAND: I believe that there is a tremendous threat to the number-crunching actuaries from employers who look at their

bills and wonder if they could not save money by hiring in-house actuarial help. I think that there eventually will be so-called expert systems that will model a lot of the thinking of the actuary and that will allow the employer to get a quick response on cost questions regarding plan changes or plan terminations. This represents more of a threat to actuaries, through a decline in the major consulting firms, rather than through the death of defined benefit plans.

MR. WATSON: I am inclined to agree with you, except that the problem for the consulting firms comes in the vanishing of certain types of work, such as number-crunching, which in turn leads to fewer new young actuaries skilled in those areas. Over a period of time, this might make it hard to maintain the quality of the consulting work.

MR. INGUI: I think that actuarial consulting firms may become more like law firms, where there is a higher proportion of professionals to the total number of employees. The current situation where one FSA has a dozen technicians working for him may have a limited future.

MR. GRANT: I would echo that. An analogous situation may be that experienced by the accounting firms, which 50 years ago served in a major role as bookkeepers for their clients. Once those clients stopped using the accountants as bookkeepers and started using them as auditors, the accounting profession exploded in terms of growth. The threat is more to the nonprofessional specialist staff than to the actuarial staff.

MR. WATSON: Where do we preserve the opportunities to continue training the people who become professionals?

MR. MALLOY: I would like to tie together a couple of the threats that seem to be emerging. I think that there will be super black boxes available, where anybody can get the number-crunching done as long as he knows what to ask for. Many of us have experienced that in our own firms, in that we see the difficulties of the young staff in understanding what they are doing because so much of their work is already in a black box. I have a long-term concern, maybe because of my own experience, that most of the judgment I do have is a result of analyzing the numbers and blue-skying or wool-gathering in the relationships found there. As a profession, we must deal with how we will create opportunities for the young actuaries to develop their judgment in nonthreatening, low-risk situations so that they can mature.

MR. WATSON: It is difficult to develop actuarial judgment unless you have actually carried out some calculations and seen at first hand what are the plausible relationships among numbers.

MR. DONALD P. HARRINGTON: Regarding the use of actuaries in large firms, as a member of the senior management team at my firm, I often get accused of territorial expansion for actuaries. I haven't been shrinking the use of the actuary; instead, I find that actuaries are useful in all areas, including pensions, medical, and the collection and analysis of data. We also find use for actuaries in the compensation area.

With regard to the defined benefit area, the part that disturbs me most is that as a group I don't believe we are serving a social purpose with a defined benefit plan. We have insulated the employees through that mechanism from burdening risks which they themselves could not handle. Defined contribution plans just do not do that.

The thrust that bothers me most is that the direction being taken by Washington seems to be based on individual case law theory; there does not seem to be a recognition of the pooling of risk for the employee group. As a consequence, we are constantly reacting to crazy rules and regulations that perceive individual injustices in rather unique situations.

I agree with the earlier point about the (IRC Section) 415 limits. The limits are primarily directed toward the use of a pension plan as a shelter; as a matter of fact, when you start to exclude the people who are involved, denying them a reasonable pension in relation to their compensation, they lose interest in the entire vehicle. If you then consider the cash flow from the favorable investment performance of the 1980s cannot be factored into your corporation, you have a rise in plan terminations. One thing keeps building on another. We have to get these messages out.

MR. VICTOR MODUGNO: One other area of opportunity arising out of the death of the defined benefit plan is the terminal funding business. Processing the annuity purchases and asset reversions from plan terminations is now a much bigger business than at any previous period. I would guess that revenues are about ten times higher now from that source than they were in the 1970s.

MR. WALLS: With respect to actuarial testimony, when an economist goes to testify, there is a whole body of academia to support that effort. Actuaries never have seemed to have, or to be able to develop, this type of base, nor in some respects have we even seemed to be interested in this type of base.

MR. GERALD F. SCHNURR: I would like to share one observation from a Canadian perspective. Mr. Grubbs noted that he expects legislation in the U.S. that will limit the availability of retirement plans as savings vehicles. In Canada, there is now proposed tax legislation which would greatly alter this availability, but in the direction of increasing it dramatically. This legislation is rather wide-ranging, and would include everything up to our equivalent of the IRA, and it has accordingly received a lot of press. The Canadian public perceives that defined contribution plans are the way to go at present, and that clearly will have some impact on what happens in Canada.