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Addressing the Financial Risks from Retirement Systems: Balancing Issues of Stakeholders: Management vs. Shareholders, Employees & Guaranty Agencies

Track: Pension

Moderator: Tonya B. Manning

Panelists: Eric J. Klieber
Brian M. Septon
Phyllis C. Borzi†
Nell Hennessy††

Summary: The inherent risk that plan sponsors face from their pension plans has changed. Thirty years ago, defined benefit plans were smaller in relationship to the plan sponsor's core business or sponsoring government's infrastructure. Once small fringe benefits, retirement plans have grown to become substantial financial commitments, with accompanying risks. How can these risks be balanced to manage the needs of sponsors, shareholders, plan participants, taxpayers and guaranty agencies? This seminar is designed to help actuaries better measure, discuss, manage and mitigate the risks that pension plans bring to their sponsoring organizations.

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†Phyllis C. Borzi, not a member of the sponsoring organizations, is the program director of Healthcare Corporate Compliance at George Washington University, Washington, D.C.

††Nell Hennessy, not a member of the sponsoring organizations, is president and CEO of Fiduciary Counselors, Washington, D.C.

Note: The chart(s) referred to in the text can be downloaded at: http://handouts.soa.org/conted/cearchive/neworleans-june05/068_combined.pdf.

MS. TONYA B. MANNING: This is yet another in our series of topics examining risks. My name is Tonya Manning. I'm with Aon Consulting, and I'll serve as the moderator for this session. I'd like to introduce our panelists. We have Eric Klieber, an associate principal and consulting actuary with Buck Consultants. We also have Brian Septon, a principal with Chicago Consulting Actuaries. Phyllis Borzi is the program director of Healthcare Corporate Compliance at George Washington University who has some background in government affairs. Nell Hennessy is president and CEO of Fiduciary Counselors and also has a government background.

The panelists will discuss corporations and plan fiduciaries and how they bear the actual responsibility and therefore risk for the operation and sound fiscal management of a plan. They're the ones who bear the risks of litigation, funding volatility, etc.. But there are also other stakeholders, such as shareholders, employees and guaranty agencies. These stakeholders will suffer if the plan is mismanaged or fails, meaning if the corporation (or plan sponsor) and plan fiduciaries don't do their jobs effectively. We have to keep in mind that these agents don't always act in the best interests of others. That's not being critical; that's just being realistic. If you are a shareholder, your goal is to get the most out of your money, so that's going to be your focus. The same goes for guaranty agencies that want to make sure that they're effectively guaranteeing the right amount in benefits, and employees who want to make sure that they have the right amount in benefits available to them as promised. Everyone has different perspectives and different things that they're looking at from the plans. To the side, you have a corporation or plan sponsor that is responsible for this.

Here are the general questions that we're going to examine. What are the risks borne by the nonsponsor stakeholders, meaning everyone but the plan sponsor, and how do those risks compete with the goals of the plan sponsor? How can an understanding of agency issues improve performance? In other words, if we can understand what the issues are of all the other players with a pension plan, how can we leverage that and roll it all into an effective delivery of benefits through a pension plan?

Through an exchange of e-mails, the panelists have come up with a list of questions that they have agreed to address, except, of course, for Nell, who is kindly jumping in at the last minute. I will go through this list and offer each of the panelists an opportunity to speak in reaction to each question from the perspective of the shareholder that they're representing. Phyllis has agreed to represent the employee perspective. Nell is going to represent the guaranty agency perspective. Eric will represent society, which is a pretty large task. Brian is going to take on corporation shareholders. Forget what they do in real life. This is who they are for the discussion, and these are the perspectives they're going to be representing.

We have put the questions into different categories, mirroring the different types of stakeholders that we have. We have society, government, employers and employees, and we have the balance of all these as the final category. All these issues mesh somewhat, as you've probably concluded with the other sessions. We'll try to keep it focused on the questions at hand, but we'll add some additional discussion if it is related to the topic we're touching on.

We're ready to jump into our first category, which is looking at society. The first question on this list is "Can society as a whole save for retirement in the same sense that individuals can?" There was a lot of discussion among the panelists about what this question means. I'm going to pick on Eric because he came up with this question. Eric, I'd like for you to explain what you were thinking of when you came up with this question, and as a representative of society, I'd like you to respond to that.

MR. ERIC J. KLIEBER: There are many mechanisms for transferring income from workers to retirees. There are family, charity, welfare, Social Security, pension and private savings. But ultimately, all retirement benefits are provided by the current workers. This is easy to see with respect to family or charity and welfare. In Social Security, there's this trust fund out there, which is accumulating all these assets.

Most of us know that, in reality, the current excess income into the system goes right out the back door and is spent by the Treasury for all sorts of wonderful things, such as highways and all those things that government pays for. Somewhere down the road, the outgo is going to exceed the income, and all those bonds in the trust fund are going to be redeemed, but they're probably going to be redeemed by selling bonds to the public—redeeming the bonds and Social Security with money that's borrowed from the public. A lot of people have said that as a result of this, the trust fund isn't real in some sense. But it does represent a real obligation of the federal government to pay Social Security benefits to the extent the trust fund permits.

What about pension plans and private savings? What happens to the money that goes into those savings vehicles? It's used to purchase securities, and what do the sellers of those securities do? They spend the money right now or buy other securities, and the sellers of those securities may spend the money, but somewhere down the road, that money gets spent immediately. If somewhere in the future the benefits that are paid from the fund should exceed the contributions, the assets are drawn down, the securities will be sold, and they'll ultimately be purchased by somebody who is currently working. Of course, the current workers also generate the corporate income that pays interest on bonds and that supports stock prices.

No matter how you look at it, the money that's paid out to retirees, to people who are not working, comes from the current workers. In that sense, I'm asking whether is it possible for society as a whole to save for retirement in the same sense that an individual can save for retirement when ultimately retirement benefits depend on the ability of current workers to provide for their own standard of living and the standard of living of retirees. As actuaries, who deal with individual plans, this is a perspective we need to keep in mind.

MS. MANNING: Brian, would you like to respond to that?

MR. BRIAN M. SEPTON: I want to add that in terms of individuals being able to save for retirement, my perspective under the current U.S. Tax Code is that in the savings for retirement and the way the U.S. Tax Code is written out, it's linked to a job. Through employment, individuals have access to essentially higher deferral limits or higher benefits than they can get individually in the market. For example, under U.S. Tax Code, you can defer a couple thousand dollars to an IRA, but a 401(k) deduction allowance is higher than that. That's one incentive right now for society or employers to be offering the benefit plan. It provides the opportunity for people to get something through an employment arrangement that they don't have access to as much through an individual arrangement.

MR. MALCOLM HAMILTON: The statement that all the benefits either are provided by or come from current workers seems to be denying any role for capital in that process. That's like saying that America's richer than Africa because Americans work harder. It's got nothing to do with the huge stores of capital that have been built up through the generations. I was wondering whether you see any role for capital in this or none.

MR. KLEIBER: It's capital that enables the workers to be productive, so, yes, there is a role for capital.

MS. ANNA M. RAPPAPORT: I wanted to make exactly the point that Malcolm led us to, that the critical thing is that by savings we build up the capital stock, but, yes, it's the future generations of workers who have to buy. I wanted to make another point inherent in this: there is no real risk-free system. People think about funding as being a risk-free system, but funding is subject to inflation and economic risk. It works well in certain kinds of stable economic situations, but it doesn't work well in others. Pay-as-you-go systems are subject to demographic risk and changes in population and whether one wants to diversify one's risk somewhat. In my view, there is no risk-free solution. A balance of both is a good thing, and that gives you a good chance in a variety of scenarios. You can build up capital and make things more productive, which helps you finance retirement. There's a lot to the fact that today's retirees depend on today's workers, and that also means that under certain demographic scenarios, you need a different pattern of work in retirement and different retirement ages.

MS. PHYLLIS C. BORZI: Brian talked a little bit about the disparity in the tax system between individual savings and group savings. The bigger problem is that we don't live in a country where there's a climate of savings, where it is impressed on people from the beginning how important it is to save. I don't think we have any shortage of savings vehicles; I think we have the wrong incentives in our Tax Code. I start from the basic thing, which is, if you have interest income, you pay taxes on it. What does that say? I came from an atypical family. My parents were children of the Depression, so from the time we were little, we had little savings accounts, and the money I earned from babysitting did not go to get the latest video game. The deal was I got to keep half of what I earned, and the other half went into my little savings account. I knew when I got old enough how ridiculous it was that these savings then would increase my tax liability.

Before we even start talking about the disparity between individual and group savings incentives, we need to step back and say that what we need if we care about people saving is to create a culture of saving from the time children are little, to teach them in school about how important it is, and then we have to make bigger changes in our Tax Code that reward, not discourage, savings.

MS. NELL HENNESSY: On the initial question of whether society can save for retirement in the same sense that individuals can, I think, Eric, you're talking basically about Social Security and the fact that under the current system the only investments that Social Security can make are in federal debt obligations. There's no reason theoretically that you couldn't invest public money in savings vehicles in the same way you invest in stocks and bonds and real estate. Federal government makes capital expenditures all the time in terms of buying buildings, automobiles or whatever. But there has always been reluctance on the part of the Treasury Department, possibly not surprising, to allow federal agencies to invest in something other than federal debt securities. For those of you who don't know why I'm representing the guaranty agencies, I was the deputy executive director and chief negotiator for the PBGC from 1993 to 1998.

The PBGC is unusual in that when it takes over a plan, the trust fund that it takes over is invested in the private market and can be invested in equities. But since 1987, PBGC has had statutory authority to invest a significant part of its premiums (all the variable rate premium, plus everything above $9 in corporate bonds). We tried in 1993, 1994 or 1995, sometime during the period I was there, to get Treasury, which is on the board, to agree to let us do that, and it said no. It's not a Democrat/Republican issue. It's Treasury versus everybody else.

If they were fiduciaries in a pension plan—and remember we're talking about the premium money, so it's not a fiduciary with respect to the premium money in the same ERISA sense as it is for the trust fund money—you would require that the conflicted fiduciary recuse itself from the decision. In this case, neither Labor nor Commerce, the other two parts of the PBGC triumvirate, is going to go to something other than Treasury bonds without Treasury agreeing to it. But it could be done.

MS. MANNING: Let's go to the next question: Are defined-benefit (DB) plans a critical mechanism for providing income security for retirees, or can they simply be replaced? Let's start with Eric again.

MR. KLEIBER: If we start from the premise of my previous remarks that all these various mechanisms are economically equivalent, how do we evaluate them? I identify three bases for evaluation. One is efficiency, in terms of providing the greatest amount of benefits at the lowest cost as well as efficiency in the allocation of benefits, and flexibility and risk mitigation. If you can evaluate all of these various mechanisms by those three criteria, I think you find benefit plans come out looking pretty good. They're efficient in their allocation of benefits and are relatively low-cost. They're relatively poor in flexibility due to the fact that the benefits are defined and therefore, to some extent, inflexible. They do mitigate the longevity risk and transfer the investment risk from the participants to the employer, but there's the ever-present risk of distressed termination, which has been weighing on us, so these are the criteria you need to use to weigh the various mechanisms for providing retirement benefits.

MR. MARK RULOFF: The issue of risk in DB plans is what's causing us the biggest problems. If you look at things from the employers' point of view, they have volatility in their contributions. That's a risk that they do not want to bear, and we need to provide them ways of getting rid of it. If you look at things from the participant point of view, we can say that DB plans are secure, but unfortunately, the newspapers are talking about DB plans not being secure. That's a risk that they probably will not want to bear, either, and would prefer to get the money now, invest it and take their own chances with their investments. When we look at things from a societal or taxpayer point of view, the taxpayers are not only giving us tax deductions, but other plan sponsors are possibly on the hook for the risk taken in these DB plans. Although we have a lot of advantages over defined-contribution (DC) plans, we need to overcome our risk problems in the DB world.

MR. SEPTON: Mark, that was a great comment. I just want to build on something regarding volatility. From the shareholder perspective, the business objectives spread long-term value to the shareholders, and corporate governance looks to align those interests, and agency theory comes in in terms of having principles and to control the behavior of the agents. But in terms of volatility in the business, from the shareholder perspective, there's a lot of volatility in business, period. Everywhere you look, there's volatility. We talk about interest rates and their gradual decline over the past couple of years. I look at the price of oil up 30 percent this year and what that's doing to business. I look at United Airlines, and I've read in the papers that it's spending a billion dollars more on oil this year than it did last year. If you remove the increase in oil prices on the airline business, things are looking much better for them. From the business perspective, the issue is volatility everywhere, and in what areas can we better protect ourselves from volatility? Southwest Airlines hedged its oil, and it's paying off big time for it. There are other ways that those same strategies can make their way into retirement plans.

MS. BORZI: I agree with what Brian said and think that the person in the audience who made the comment makes a common mistake in terms of characterizing the employees' interest in this because employees' interests in risk are not monolithic. There is not this groundswell of public opinion, of the overwhelming majority of employees in this country who participate in employer-sponsored plans, that they want to manage their own investments. The fact that we don't have 100 percent participation in self-directed 401(k) plans suggests to me, and I think this is a future area for research, that there are a lot of reasons besides inertia why people don't sign up for 401(k) plans. The autopilot 401(k) plans deal with the inertia question, but I think that there are a lot of employees in this country who are afraid of assuming the risk. They don't believe they're capable of doing it. They don't believe they have the expertise to do it. In some cases, they just don't want to do it.

I have been in this business for 30 years, and I don't feel particularly capable of deciding how to roll the dice so that my entire retirement income depends on my skill, luck or experience in the investment market. When we're looking at this question of whether our DB plans are a critical mechanism, I think the answer has to be yes because both employees and employers have a common interest in shared risk. I don't think we can design a system, nor do I think it's a good idea from a policy point of view to design a system, where the risk is borne by any one of these parties solely. What we need is a shared system of risk and rewards.

I think the ideal system is a system in which every American is covered under both a DB-type approach and a DC-type approach. Both have risks and rewards, and over people's work careers, one or the other may be better for them. I don't believe that we ought to have a system that's entirely DB, but I also don't believe we ought to have a system, and here I'm talking holistically by a private pension plan system, an employer-sponsored plan system and a Social Security system, in which individuals bear the majority of risk for their own retirement security. I think that's a bad idea. Call me a maternalist or paternalist. I've been accused of worse in my life. I know every time I raise the specter that not every employee in America is fully capable of taking on investing his retirement income, I'm accused of not trusting the good judgment and talent of the American people. I'm happy to take that.

MS. HENNESSY: I think DB plans do play an important part, and it's difficult for us to replicate it using other mechanisms. When I look at a DB plan, I see it as two parts. One is the accumulation phase, and the other is the distribution phase. I think DB plans are generally superior in both respects. I probably shouldn't say this because somebody will beat me over the head in this crowd, but I don't have the same feelings about cash-balanced plans. When I say DB plans, I'm talking about traditional DB plans.

When you look at the statistics in the accumulation phase, interestingly, the performance of individual 401(k) plans investment-wise is pretty similar to DB plans. It's only when you look below it that you discover the problem, which is that the investments are fairly bipolar. The biggest investments in DC plans are money market or stable value, low risk, low return or employer stock. The high returns on employer stock come at a risk, and with all these employer stock cases, there is paper after paper talking about the lack of diversification. The greater risk is not compensated for by the greater reward because you can't tell whether any particular company is going to be the winner or the loser over time.

That's just the people who invested. The bigger problem is the one that Phyllis has identified, which is that in our current system where participation is optional, many individuals are frozen in uncertainty. One of the papers presented at the Wharton Conference a couple of years ago said participants are less likely to participate in a plan if you give them too many investment choices because they're frozen. All of us said, "Okay," but a company I talked to once had over 200 investment options. It never dropped an investment option. When you read the paper, the number above which people have problems is two. This leaves me to think that the option you should give them at the beginning is, Do you want to invest your own money, or do you want to let somebody else do it?

On the distribution side, people overestimate how much their savings are going to earn, no matter what they're invested in, and they underestimate how long they're going to live and how much they'll need in retirement. They don't understand draw-downs. There was a wonderful article that Ron Gebhardtsbauer did for The Women's Institute for Secure Retirement, of which Phyllis and I are both on the board, as is Anna Rappaport. He was advising his mother on buying an annuity and showing her how when you looked at the pattern for minimum distributions out of the DC plan, and you looked at the pattern of buying annuities, the annuity was clearly far superior.

That's an education that is beginning, but unfortunately, people are distrustful of being sold annuities as opposed to buying them because they're the right thing.

MS. MANNING: Were there any comments?

FROM THE FLOOR: Yes. I'm interested in this comment about what the media is telling us about DB plans and not being able to satisfy the promises of the plan as with United Airlines and, going back, LTV. I don't know how many plans go through PBGC and finally have enough money or don't go to PBGC because they have enough money even if the plan is terminating. What I see in the media, and I don't see any counterarguments by the SOA or the Academy, is the perception the public has that pension plans are going bankrupt. The companies I see in the media are companies that I would not buy stock in. They're debt-heavy and union-negotiated, and they're probably going bankrupt for corporate reasons. The pension plan gets dragged into that.

I worked personally with the Resolution Trust Company (RTC) FDIC back in the late 1980s and early 1990s on the savings and loan (S&L) and bank closures, which was probably one of the biggest financial problems we've had. There were no participants of the plans that we terminated who were not paid their full benefit. Most of the plans had excess assets that were reverted over to VRTC. I would like to hear more about the comment that was made about the perception that DB plans are big old white elephants that drag you down into bankruptcy. It's an issue actuaries have to face, along with everything else, that the DB plan is a black cloud.

MS. MANNING: Some practitioners believe that DB plans are becoming a scapegoat in some of the recent corporate downfalls, where it seems to be easier to point at the pension plan than to point out some of the poor decisions that management may have made in running the company.

MS. HENNESSY: Although if you look at the pension plan, if you look at the financial accounting number, which values the liability at a relatively low level compared to long-term rates of return, the GM plans are 90 percent funded. I'd like to respond on the S&Ls. One of the reasons you saw overfunded plans in the S&L industry is they were almost all final average pay plans. Final average pay plans have a built-in cushion under current law, which the proposals are about to eliminate. In the next wave, I think you might see something different because as the accounting rules would require for accounting for pensions, they fund toward the projected benefit. There were a few underfunded S&L and bank plans that PBGC took out of receivership, but you're right. The majority of them it did not.

I think that what we're going to see the next time, if we go through the same economic cycle and assuming there are DB plans left and if these proposed rules are enacted, is that we'll have inadequate funding when interest rates are high, and then as interest rates inevitably drop, plans will be underfunded. Most of the underfunding problem in cases like United and U.S. Air come about not because of investment losses, but because the interest rate drops, and the funding is being driven by the current lower interest rates, rather than the long-term rate of return. It's that instability. We were the independent fiduciary for U.S. Air's DB plans for collecting the contributions. If you looked at the regular minimum funding standard, there was no reason to terminate these last couple of plans it had to terminate. But when you looked at the depths of reduction contribution, it was huge. It just couldn't afford it.

MS. RAPPAPORT: I'd like to address this DB question by giving some criteria that I think we need from a participant and societal point of view. We need plans that work well without employee action, that is, for people who aren't going to decide, stay in defaults and won't save.

We need plans that pay out regular income. I believe that's important. We need plans that are secure, and that reflects a combination of the total societal picture; plans that work well for a variety of career and family patterns; and plans that provide enough money. Often when people say, "I don't want this kind of plan," what they mean is, "I want fewer benefits, and I want to pay in less money." We don't want to recognize how much it costs. Getting to that, I would say that DB plans are a valuable part of the mix, but there are other mixes. Another mix would be higher Social Security benefits. We don't seem to be going there, but there are other solutions, and at the same time, given the total mix of career benefits, we need to not forget that Social Security, which is primarily a DB system today, is an important part of the mix, and I'd like us to focus on these criteria.

MR. SEPTON: Personally, I agree with you. From the shareholder perspective, the purpose of business is business. It's not to set the public policy. From the corporate perspective, if that can come through government and through public policy-making, there might be something to put on the table. From the purpose of a business, it's back to making money for the shareholders. To the extent that it can be legislated, maybe that's something that could work.

UNIDENTIFIED SPEAKER: I'm going to add one comment. When we talk about incentives and the projections for the employees and the shareholders, you have to separate individual industries and individual companies. With the airlines, the steel companies and probably the automakers, you're looking at industries and businesses where the liability for the pension plan often dwarfs much of the rest of the capital in the business. British Airways is often called an overleveraged hedge fund that owns a few airplanes. When you look at it from the point of view of the risk to society, through the guaranty agency, through the rest of the employees and the rest of the shareholders, for some of those companies, a different structure, such as maybe investing in bonds so that your liabilities are perfectly hedged, might be better even for the shareholders because you might not end up in bankruptcy.

You could make an argument that for some of these big companies, if they were perfectly hedged, they might not be driven to the point of having to dump their plans and also might not be driven into the bankruptcy court because of the funding requirements for their plans. But because of the incentives that are placed on management, particularly, I would argue through the Financial Accounting Standard (FAS) 87, you've got this perverse system, where all plans invest the same way and are driven to the same kind of decisions to stay competitive in the stock market, whereas the shareholders' best interest isn't necessarily for that plan in the long term to do that.

MS. MANNING: They're basically playing by the rules.

FROM THE FLOOR: I want to add to Anna's conditions. Part of the problem globally that the world has faced, and I particularly look at Italy, France and Germany, is the social security systems are hopeless. That's being kind. The problem comes from asset/liability mismatching, and that can be simply that it's not funded or the economy doesn't match the liabilities promised. With any system you have, if you make a promise, fund it and match assets to liabilities. If you can't match assets to liabilities, it either means they're incomplete markets, or you need to change the liabilities in such a way or define them differently so that they can be matched. Whenever you don't have a match with assets and liabilities, you've got a risk, and then it's a question of whether the economy can afford that risk. If you're not going to fund, you get an even worse risk. It's easy for politicians to promise benefits to get elected; it's difficult for politicians to take away benefits. They get unelected. I would add fund and match to those conditions.

MS. MANNING: We'll move on to our second category, which is government. There are only a few questions here. Does the government have a stake in preserving the DB system? If so, how can it best achieve this goal? Looking at the government as a stakeholder, does it have a stake at preserving this system? I'd like to start at the opposite end of the panel and give Nell an opportunity to respond to that.

MS. HENNESSY: I think that the PBGC has a statutory obligation to promote DB plans, unless Congress changes the statute. That part of the government at least has a stake. There is a societal interest in having stable retirement income. To the extent that participants have retirement income other than Social Security, it puts less pressure on Social Security. The DB system is more likely to produce that kind of steady-state income than DC plans.

MS. BORZI: I agree with Nell. From the point of view of employees and participants in this plan, from the point of view of individuals, we've evolved over centuries from a system in which the family was the primary caretaker, and it was a family responsibility to make sure that the young and the old were taken care of. We've moved away from that to a system where the role of the public programs—and by that I mean Social Security, Medicare and the tax system for that matter—because the taxpayers through the incentives that are provided in the tax system whether they like them or not, induce certain kinds of behaviors, supposedly socially responsible behavior.

Right now in terms of answering this question about the role of the government and the role of the government in assuring adequate retirement income, the jury is still out as to what the current policymakers believe the role of government is. It's not the slightest bit clear in the days of divided government and sharply partisan, ideologically disparate views. I don't think anybody can say what government believes. If you tell me who government is, I can probably tell you what it believes.

The other thing that I learned from my 16 years of working on the congressional staff is that the policymakers are rarely the leaders. They're often the people running after the train, hurling themselves onto the caboose and trying to get to the front of the train before it pulls into the station, where the brass band is waiting to greet them.

It's all of us in our collective and individual roles who have to determine whether government has a stake. If you look at the polls, while they may embrace a smaller government as a theoretical concept, when it comes right down to it, what most of the American people expect government to do is a pretty substantial thing. I think if we were to wander out and interview people on the streets and ask them whether they felt government had a role, broadening the question to not just DB plans, but to retirement, security and keeping a private retirement (by private I don't necessarily mean only private sector employers because I'm including state and local governments and employer-sponsored systems), if you ask them if they think that there's a role for employers in this, I'm positive they'll say yes by overwhelming numbers. I think there is a role for government.

MS. HENNESSY: The other thing I think on the government side is that there's virtually no one in Congress and few people in the administration who understand how DB plans work, how funding works, and what the long-term assumptions should be.

MR. KLIEBER: One of the major themes of ERISA and of the major pension legislations since ERISA has been the liberalization of vesting requirements and the broadening of participation requirements for all kinds of retirement plans. I think this has hurt DB plans. DB plans primarily benefit those who are retired and those who are approaching retirement, and DC plans are more efficient for the young. By requiring that we cover and vest young workers in DB plans, thereby forcing employers as a condition for covering their older workers to also cover in many cases a majority of workers who are younger and who don't care about the plan, employers have decided that their DB plans are too inefficient in providing benefits.

It sets up a competition between the older workers and the younger workers, and in many cases, the younger workers have won out by employers who've ditched their DB plans and have gone to DC plans. If the government wants to revive DB plans, it needs to acknowledge that workers at different stages of life have different needs. Just as childcare benefits benefit the young more than the old, DB plans benefit the old more than the young. Employers should have greater flexibility in targeting benefits at the people who need them.

FROM THE FLOOR: I had something printed in *Pensions & Investments* about 20 years ago, advocating a simple change to the way that PBGC premiums were assessed, which I thought would be a great help, and I still feel that way. The simple change was this: If the revenues that the PBGC needed were X dollars, they didn't necessarily have to be funded from just DB plans. You could apply a smaller levy to all tax-qualified plans. I realize that may appear a little bit inequitable to DC plan sponsors, but I view no less inequitable the fact that everybody pays for school systems, even though some of us don't have children. That would have addressed what I felt was one of the significant misconceptions about the creation of the PBGC: that DBs were always going to be around. I don't think it recognized that having a DB plan is truly in many cases a voluntary act.

MR. SEPTON: I'll just make one point regarding the shareholder perspective in government. It's back to the point of volatility in business, and from the shareholder perspective, there's a lot of volatility everywhere. Regarding DB plans, we have talked about the volatility, but to the extent that we can nail down issues about what the funding roles will be, what the basis for an interest rate will be, if we can peel off pieces of what the volatility is, we can better focus on how to manage what's left. But in terms of there being legislative or backlash risk, if we can sort through those things from a shareholder perspective, we can begin to move toward certainty in the DB arena.

FROM THE FLOOR: I have a reaction to something that Eric said about the fact that young people don't need DB accruals. I respectfully disagree. I think it's a matter of needing different designs. If you look at a cash-balance design, it gives a meaningful benefit accrual to young people, yet it provides the guarantee of the interest. Whether the employer decides to immunize that by buying bonds to hedge the bet or gamble with equities, that's the employer's risk. But from the employee perspective, something that provides a meaningful accrual at a young age I think would be appreciated long term. It could be an inflation-indexed benefit. It could be a cash-balance type of benefit, but it's a matter of coming up with good design and trying to figure out how we modify statute to make sure that nobody has fear of crazy judges.

MS. HENNESSY: Can I just take Ethan on one point? I don't think the problem is entirely crazy judges. A significant part of this problem is one of your members, who took bizarre positions that led to this whole ___, so I think the judges are simply responding to an actuarial issue that at least one actuary, and probably more, in the government brought on us.

MR. KLIEBER: Ethan is correct that a cash-balance plan is more efficient in providing benefits to younger workers. But then if you're stuck with the same cash-balance arrangement for older workers, that becomes less efficient for those older workers. You have the conflict between cash-balance and traditional DB formulas, similar to the conflict between DC and traditional DB formulas. What might be ideal would be a plan that starts out of the cash-balance plan and then converts to a traditional plan at some point—

MS. HENNESSY: And pays benefits in the form of an annuity.

MR. KLIEBER: —benefits in the form of annuity, yes.

MS. MANNING: I think that would be ideal from the employee perspective, but perhaps not from the plan sponsor side.

Let's move on to our next category. I'm looking at it from the employers' side. We have a lot of questions here, which we can merge into a couple of discussion topics. The one that I'd like to focus on is why do employers offer DB plans? If a corporation is just trying to cut costs, why offer anything? I think most of us operate under the general assumption that employers provide retirement benefits to be able to compete with other employers that provide retirement benefits. They're generally going to provide a level of benefits that is most likely to be competitive, depending on their industry, but why do they choose to offer DB plans? I'd like to touch on that question and then later move on to whether U.S. employers can offer these plans and still compete internationally.

Let's first touch on why we feel employers are choosing or not choosing DB plans. Then we'll move into whether, if they do choose to sponsor one, they can compete internationally with corporations based in other countries that perhaps don't have the same cost for employee benefits. We'll start with Brian.

MR. SEPTON: On this topic of why some employers are offering DB plans, I'd be interested in hearing from everybody here more than from myself because many of the things that I'd want to talk about have been covered. Whom do you want to reward? Do you want to reward the person who has been there longer? Do you need to have an orderly adjustment of your workforce? What about U.S. Tax Code allowing you to offer a DB plan with essentially higher limits than the DC plan in the U.S.? Retirement plans in general enable workers to get something wholesale with the cheaper free structure than maybe they can get retail or individually. At this point, if there is anyone who has any additional reasons beyond what we've covered, I'd love to hear them.

MS. HENNESSY: We have the Methodists creating a new DB plan, a traditional DB plan. But they have the advantage of not being subject to the ERISA funding rules.

MS. BORZI: There is also a question of size. One of the things that I haven't heard discussed is that we seem to be talking about plans, and the implicit assumption in most of these discussions is that they've been plans of fairly large employers. This global question assumes that you've got an employer of a decent size. The motivation for having a DB plan or not might have some connection to the size of the employer. Even having said that, I don't do a lot of work with small employers, but when I worked on the Hill, I heard from small employers that said two kinds of things. The ones that like DB plans were the owner-dominated small-employer plans, and the reason they liked it was self-evident. They could get the biggest bang for their buck themselves. They had to drag along the common-law employees, but for their own benefit they could get a lot more out of the DB plan than they could out of a DC plan.

On the other hand, among small employers that were concerned only about minimizing the complexity and additional cost beyond just making the contribution (I know we're going to get into this question about employee understanding, so I don't want to preempt that discussion) there's some difference of opinion as to whether or not a DB plan might suit the owners' long-term goals.

MS. MANNING: Sometimes if an employer chooses to sponsor a DB plan, a lot of the rationale is "What about me?" Sometimes the DB plan is closed and terminated, but the DB nonqualified plan survives. Part of the problem is the limitation on the benefits that the employers can get out of the qualified plan. If you have to have a significant wrap in a nonqualified plan, why not just have a nonqualified plan to begin with? Some of the statutory salary and benefit limitations that have been imposed on the DB plan have taken a lot of interest in the plans away from the key players.

MS. BORZI: Absolutely. One of the biggest mistakes that Congress has made over the years is the depression or freezing of the 415 limits as a way to do who knows what. Ostensibly, you save revenue, but the less stake that the decisionmakers have in the benefit continuing under the DB plan, the less likely they are to continue the DB plan or improve it.

MS. HENNESSY: Yes, although I think that the nonqualified plan issue is not one for small employers because the small employers, the highly paid, the decisionmakers, are in fact the shareholders, and they can see the direct tax impact of the nonqualified. They're going to pay taxes either in the entity or out of the entity, and many of them are now organized as LOCs, so they don't have nonqualified vehicles other than annuity vehicles.

I would disagree with Phyllis, and we often see eye to eye. In this case, I think she's expressing the view that's expressed by the tax-writing committees, which since she was on a labor committee is a little bizarre. In my experience, while there is for small employers a concern for the owners, what I find in a lot of small businesses is that there is a concern for long-service employees as well.

If you go out to an upscale restaurant, you will note the age of the waiters. They are not children. Many old-line restaurants have old-line employees, and those are a type of small business where if you've got an owner, and he's got a waiter or kitchen help who have been with him for 20 or 30 years, which is about when they start thinking about setting up the plan. They want to make sure those people can retire, too.

MR. ALAN MILLIGAN: I work in the public sector, and one of the major reasons that some public-sector employees sponsor DB plans has to do with incenting employees to leave at a young age. This is particularly important in the police and fire categories. You definitely do not want to have old policemen or old firemen hanging around. There's a concern about disability costs and so on for that, and there's the image. That's a major factor in the public sector.

MR. SEPTON: From the corporate perspective, you want to be able to provide employees with a comfortable retirement to avoid a backlash of having to kick people out and their not being able to retire or get other jobs anywhere.

FROM THE FLOOR: I've spoken to a lot of CFOs both in the U.S. and in the U.K. One of the important drivers is control of all the aspects, in particular the investment policy. In the U.K., we've seen a huge increase in the freezing of plans, and it's got a lot to do with the governance, with the fact that the corporation has no control of the investment policy. It's pretty much in the hands of the trustee group, which in turn is in the hands of consultants. It is told to invest 70 percent or 80 percent in equities, whatever it may be, with no tie-in with the liabilities, and the corporation feels that that is too much risk. There's nothing it can do anything about, and therefore it terminates the plans.

In the U.S., it is different. I would say at least half of the CFOs that we've spoken to do like DB plans. They want to keep their DB plans going if they can. They may want to cut back on benefits because they are more expensive than they had originally anticipated, but they want to keep the DB plans going and are looking for ways to do that. They wouldn't mind paying higher contributions, provided they were certain. They don't want to be in column six. They want the issue to go away.

The first instinct of CEOs or CFOs when you talk about labor issues, be they pension or medical, is to hide under the desk. They are afraid of them. They know they've got potentially hostile employees. They just want this issue to go away. They want clear rules. They're willing to fund. They're willing to do whatever it takes to make this plan manageable going forward, and that's the issue in front of us. I don't think there is this big move by corporations to move from DB to DC. There certainly are some companies that want to do that, but there are a lot that don't.

MS. HENNESSY: Part of the reason for that is that the U.K. more rapidly than the U.S. went to mark-to-market on the liabilities, which creates the volatility unless you do matching of assets and liabilities. In the U.S., for the majority of plans, they have been able to fund until recently on a steady state using a long-term rate of return. It's only as they dipped below the level where they had to pay the debts of reduction contribution in the past couple of years that that's changed. That makes a huge difference.

The other thing is, in my role at the PBGC, I often had to talk to CFOs, and the one thing I can say is I rarely found a CFO who should be allowed to talk to labor. They are completely insensitive to the HR aspects of their own businesses.

FROM THE FLOOR: I wanted to respond and add a little bit more to a comment that Nell had made regarding the Methodist Church putting in a new DB plan. That was an instance where a DB plan was a perfect fit for a number of reasons. Though 401(k) plans and the focus on DC plans has been a relatively recent phenomenon over the past 20 years, the Methodist Church was the first one on that bandwagon. It switched from a DB plan to an all-DC approach back in 1981. It's had close to a full cycle to see how that works. It did have issues with certain of its employees not having the coverage they wanted, not having enough to live on. It also had the issue of pastors who were in that DB plan during the 1980s and 1990s and ended up where the only way they could improve their standard of living was to retire.

There was a big feeling that it had overpaid. It had provided too much retirement income and recognized that the importance of having the right retirement income is key in its situation, especially when its concern was for the entire lifetime. It wasn't just building up to retirement, having the lump sum and then going on. It's concerned with the entire lifetime of these people. That's a situation where it is much better fit from a workforce management perspective, as well as from a cost perspective because you weren't throwing dollars into plans or providing excess benefits.

A key thing for us to consider when we're trying to identify why some employers offer DB plans and some don't is no one size fits all. What's going to be important is to make sure that if the train is flying by, and it's flying toward DC, you can't affect the direction of the train by watching it go by or standing in front of it, you have to be on it. Even if it's not going exactly the right direction, you have to get on it to affect it. A key thing for us to do as actuaries is listen to our clients and understand that some situations aren't right for DB plans and some are. The important thing is to be part of that decision and part of that discussion.

MS. MANNING: The Methodist Church is an excellent example of paternalism. The church certainly does not want their ministers living in poverty after they retire. That was probably one of the largest drivers for their recent decision.

MR. SEPTON: In addition, the employees of the Methodist Church, if we're talking about the ministers and clergy, likely couldn't get another job outside the Methodist Church upon retirement. Maybe the same is true about a nuclear engineer.

FROM THE FLOOR: The other DB issue it had was that a lot of ministers are second career. People hit their midlife crisis and decide to be ministers. One other thing I'd like to leave from that is almost every discussion about the Methodist Church putting in a DB plan that I've heard, even the comment earlier, is there's a "but." "But the church is unique." It's not unique, and there are situations where a DB plan is the correct answer, and we want to be careful about qualifying that there's always a "but," that we anticipate that most sponsors should not have a DB plan. That's not a slam dunk. There are a lot of situations where sponsors should move away from a DB plan, but there are a lot of situations where they should not. I think we need to be open to that possibility.

MR. KLIEBER: The key is that a DB plan seems appropriate for employers where the workers or a high proportion of them are expected to work until they retire. Obviously, that would go for the pastors in the Methodist Church. The skilled trades have traditionally had DB plans because once people met the training requirements, chances are they weren't going to get a better job doing anything else, so they generally worked until they retired. There are other types of businesses where this is the case, and those businesses have been the most supportive of DB plans.

MS. MANNING: Let's move on to the employee perspective. We have a lot of questions again under this category, but they also can be grouped into more general discussions. First, why aren't more employees demanding DB plans? It's often been said that employers aren't going to go through the trouble of sponsoring a DB plan unless the employees go through the process of demanding that these benefits be provided or show a clear preference for these types of benefits. Second, should the employers go ahead and honor their employees' desire for full control of their retirement benefits, given the employee would like to achieve this by having all of their retirement benefits provided in a DC plan? In other words, if employers are hearing that the employees want to have control through a DC plan, should they go ahead and honor that, even if there are other reasons, such as paternalism, where it may not be the best approach?

Third, would employees be more loyal if they better understood and were more focused on the service-based rewards of DB plans? If they're in a DB plan, would they be more loyal if they understood the plan and understood that there was this nice carrot at the end of their 20-year working career? Let's back up and look at why employees aren't demanding DB plans.

MS. HENNESSY: If they don't already have a DB plan, I don't think they understand and appreciate it. I also think that the traditional DB plan isn't as attractive to the younger workers. I'm not sure that the answer is to exclude them, but when I left the government in my 20s, I cashed out like everybody else. Luckily, I have the right to put the money back. But there is a premise here that is incorrect. If you look at the cash-balance cases, you're seeing lots of employees who want a traditional DB plan, who had a traditional DB plan, and who realize how important it is. I think that's the best evidence.

MR. KLIEBER: Most of those seem to be older workers, though.

MS. HENNESSY: Forty doesn't look so old to me anymore.

MS. BORZI: Part of the problem is a combination of what Nell was talking about before and what some of the others in the audience and some of the other panelists have said. Nell said before, and I absolutely believe it because my experience bears it out, that policymakers don't understand how DB plans work. Regular people don't even understand that there's a difference between DB and DC plans. These are concepts that for most individuals are not in their lexicon or vocabulary. What people want is a good pension, and when people think about pension plans, they think about plans that pay them benefits over time.

I think the appeal of DC plans over DB plans, even if people don't understand that there is a difference between them, is the relative transparency of what you're going to get at the end of the road. I don't think people think about the fact that the sum of money on their 401(k) statements may or may not be sufficient to last through their retirements. They can at least track their progress, because they get these statements that tell them what the value of their accounts are. Whether that translates into a benefit calculation, I don't know.

It's difficult for people to understand what a DB plan is, which is the reason I like

Anna's formulation of the principles regardless of whether you use DB or DC, or whether you create some new animal. What employees are looking for, and it's remarkably close to what employers and perhaps shareholders are looking for, is a stable retirement income. Regarding the premise of this question about employers honoring their employees' desire for full control, how many of you have had clients that took a poll of their employees before they instituted a self-directed 401(k) plan? There are perhaps a handful, but I would think that the overwhelming number of employers think they know what is best for their employees or what their employees want.

MS. MANNING: I think employers believe that what they personally want is also what their employees want.

MS. BORZI: Right, and that's what I was going to say. One of the things I learned in my first couple of years as a lawyer was that the people who make decisions about the design of the pension plan are thinking about what they would want if they were employees, because they're covered by these plans too, rather than what their rank-and-file employees want. I'll give you a quick example.

In my local community, the town decided that it wanted to provide benefits for the people who work for it. There are about 27 to 30 employees at any given time, so it gave them a 401(k) plan. Its long-time bank trustee decided that it didn't want to be in the business of managing a 401(k) plan for that measly little number of people. So it told the town that it'd be happy to be the trustee, but its fees were going to increase by 400 percent.

Needless to say, these people were on the market for a new trustee and went through the process, even though they're not covered by ERISA, of a request for proposal (RFP) and brought in all these people. Because I knew the mayor, she drafted me to be the pro bono consultant to the town. Each one of these three household-name mutual fund people came in and offered a variety of programs. As I sat at that board meeting, all of those members of the board, and they're all outstanding people in the community, but they're all professionals, were talking about what they would want. The guys who pick up the recycling bins in my town probably are not interested in 42 investment options and the ability to invest in international funds. I hate to sound condescending, but that's probably not what's on the top of their list.

If you asked them what they wanted for a retirement benefit after working 20 to 30 years, because those employees are just like the employees that Nell was talking about in the restaurant industry—they work for years and years, everybody in town knows them, and they're part of the community—what I, as a citizen taxpayer want for them, and what they want for themselves, is a decent retirement income. I'm not sure that a 401(k) plan is the way to do it. I know for sure that there wasn't a person in that decision-making position who was thinking about how those employees would fare under the design decisions. They were thinking about what they would have wanted.

That's atypical. I'm not painting everybody with the same brush. I think there are people who do think closely about what their employees want, but that's an example.

MS. MANNING: Consultants often provide employers with illustrations of how the company's employees would fare from one plan to another. The decision makers then see that they will personally have a decrease in benefits if they change from a DB plan to a DC plan, and that often is a large player in their decision to keep the DB plan.

MR. SEPTON: Business ethics come into play a little bit here. One rule of ethics, although this could probably be argued, is that honesty brings long-term shareholder value. We've heard from some people in this room and from plan sponsors, or people who work for plan sponsors, that their benefit plans are inadequate, and some people say inadequate is a compliment to the plans. I wonder to what extent plan sponsors would say to their employees that their benefit plans are inadequate. It may or may not be true, and it depends on all sorts of things, but one reason employees may not look at DB plans may have to do with an education, honesty or business ethics thing.

MR. GEORGE BERAM: I'm currently working in South Korea and have been there for the past 2-1/2 years. In South Korea, there's a blank slate in that there are no real private pensions. A law was passed that there will private pensions, DB or DC, starting December 1. It's a fascinating situation.

What I see in the U.S. is that employees are weak. They have no power. They're afraid to speak up. They have been beaten down by Congress, accountants, actuaries, CEOs and CFOs and simply have no power. Why aren't employees demanding DB plans? They're afraid they'll lose their jobs if they say anything. One of the differences in Korea, which is interesting, is that an employer must establish either a DB or DC plan, but employee consent is required. Therefore, employees are taking a major interest in this decision.

MR. SEPTON: I would call that social capitalism, though, which would be separate from the U.S. and Canada, where employees have less of a stake in the ownership of the company.

FROM THE FLOOR: I have two comments. I don't think the right question is why employees aren't demanding something. You can also ask why employees aren't demanding more money. They don't demand it because they don't think they're going to get it, they don't think they deserve it, or they don't think anyone else would give it to them. The issue is that if you told employees what the benefit is worth, properly priced and not mispriced, would they think that was a worthwhile expenditure of their compensation? The problem you have right now is if you work out the proper pricing of these benefits at today's interest rates, real or nominal, it's no wonder older employees like DB plans. If you went to them and said, "Do you like it 30 percent of salary?" They'd probably say "No." They'd think it's pretty good for 10 percent of salary, but these things are expensive all of a sudden. It's no wonder that employees who appreciate that would like them. But that of and by itself is not enough to make it an economically viable proposition.

The second unrelated comment is the issue about all the investment choices. I don't know what the story is in the U.S., but in Canada, many of the plans that have gone there have gone there out of fear of litigation. The thing that they're concerned about is it's not that they think the rank-and-file employees are desperate to have international investments, but they fear that 20 years from now, if it turns out that international investments were the best things to have invested in, and they denied that opportunity to their employees, the very employees who now have no interest in them would all be alleging that that's the thing more than anything else they should have invested in and wanted to invest in, and the plan denied them that opportunity. Maybe it shouldn't drive decision-making, but there is concern that if you deny people options that in retrospect turn out to be valuable options, you'll get in trouble.

MR. RICK ROEDER: I want to compliment the man over there talking about Korea. He hit it dead on and stole some of my thunder. It is clear to me, especially when you look at the difference between the public sector and the private sector, that the degree of unionization has a huge impact on the level of clout that employees have. Out in California, when our governor proposed a DC plan in January, I was asked to testify at state senate hearings in Sacramento the following month. He's run into a firestorm because the public-sector employees, who are heavily unionized in California and to some degree most of the other 49 states, have a lot of political clout. They have a lot of political capital, and they want their DB plans. My observation is that in the private sector, especially with outsourcing of jobs, there's not the same level of ability of the employees to effectively enter into the debate.

MS. MANNING: We have one more category of questions, which is balance. I'd like to approach this by letting each of the panelists comment on this briefly, and then we'll close. As we look at the balance of all the stakeholders' needs, the first of our two questions is, How can you balance employers' needs for funding flexibility and predictability with the employees' needs for adequacy and predictability in their retirement income? Note that the word "predictability," not "lack of volatility," has been used. A lot of employers feel that volatility is not necessarily bad, as long as they see it coming down the road. The second question is, How much responsibility for adequate retirement income should be placed on each of these stakeholders?

MR. SEPTON: The shareholders want to achieve that equity risk premium, and so shareholders want the long-term value. To the extent the volatility or the unpredictability of noninvestments issues can be taken off the table, that could help. I refer to legislation and other legal issues.

MS. BORZI: Let me take the second question first. I think it ought to be shared responsibility; each of the parties ought to bear some risk and ought to be at risk. That's what differentiates us in the U.S. from some other countries. That's, in my personal opinion, the balance we ought to strike.

As far as the first question is concerned, if I knew the answer to that, I would be there writing the silver-bullet legislation. It's hard to figure out where the balance is. We haven't done it so far.

MS. HENNESSY: We have to recognize that we can't always guarantee things for the participants, and we've gone so far toward protecting the participants that we've destroyed the very plans that those rules were designed to protect. The inability to get rid of lump sums is a perfect example. The only way to do it in the current climate is legislative, and I see no hope that it's going to go in that direction. All signs point to greater volatility and greater instability.

MS. BORZI: I'm not so sure that the pendulum has swung so that we've protected participants. What's happened is that there are people in government who believe they've designed a system to protect participants, but participants don't feel protected and are not necessarily protected.

MS. MANNING: Thanks to each of our panelists and to everyone for your discussions and insightful comments.