Pension Section News

January 2005 – Issue No. 57

Janurary 2005, Issue No. 57 | Newsletter of the Pension Section | Published in Schaumburg, Ill. by the Society of Actuaries

Society of Actuaries

Pension Section News

Defined Benefit Plans vs. Defined Contribution Plans

by Mark Ruloff

Employers and investors have suffered recently from taking too much investment risk inside their defined benefit (DB) plans, producing calls for more transparent accounting. Some employers have tried to eliminate this pension risk by moving to defined contribution (DC) plans. However, this is not the only, or even the best, option available.

Move to Defined Contribution Plans

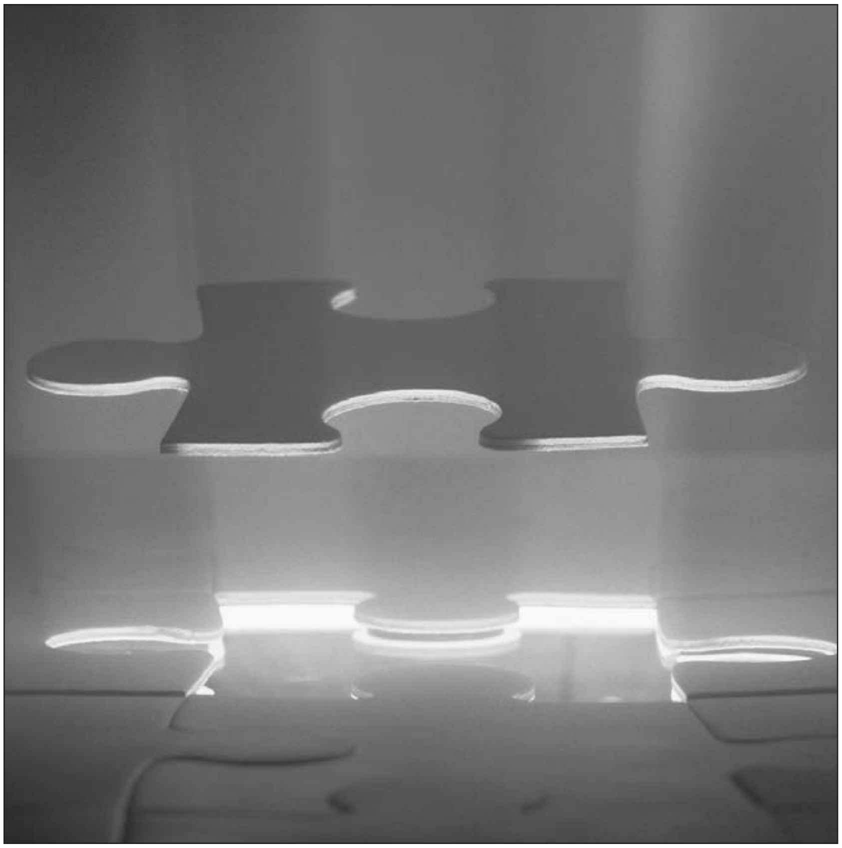
Many plan sponsors see moving to DC plans as a way to reduce the investment risk. However, the risk is not actually reduced but shifted to employees. In fact, the risk actually increases.

Bad for participant

The shift to DC plans passes the risk to the participants, who are far less able to manage it than shareholders and lenders. Participants lack the connections and resources to get the same quality of investment advice available to a large DB plan. The participant also now has a longevity risk which was less in the DB plan due to the pooling of individual risks.

(continued on page 18)

contents



Bad for plan sponsor in the long run
Although the investment risk is in the participant's hands, the employer is also vulnerable. When the market turns down, the employer will suffer from low employee morale as DC assets deteriorate. At the same time, the plan sponsor might want to reduce staff. But with low account values, individuals eligible for retirement will be reluctant to leave, keeping payroll costs high. In addition, without a fully funded DB plan, the employer will not have the tools and the spare cash needed to encourage departures through an early retirement window.

Also, when the economy is good, the plan sponsor might want to increase staff. But at the same time, current employees might see sufficient DC funds for them to retire. Not only will the plan sponsor be pressed to hire new employees to meet growing demands, but he will also need to replace retiring employees.

Bad for society in the long run
As participants make bad savings and investment decisions, they will be left without the means to pay for their retirement. Then society (e.g., taxpayers) will need to make up part if not all of this difference.

Move Assets to Bonds

A better alternative would be to make less risky investments in the DB plans.

Good for shareholder value
Over time, the lower anticipated returns from bonds compared to equities would be expected to raise contribution levels. However, financial economics argues that this increases shareholder value and has socially desirable effects. The benefit to shareholders can be determined by considering the entire portfolio of investments of the shareholders and the tax advantages to investing inside a qualified plan and the tax advantages of investing in equities.

Each shareholder has a certain level of risk that is optimal for him. He achieves this level by dividing his portfolio appropriately between equities and bonds. He prefers to hold his highly taxed assets—bonds—in the tax shelter of a corporate pension plan, and his lower taxed assets—equities—in unsheltered accounts.

Good for participants
When the economy turns down, some employers will close their doors. As employees lose their jobs with this employer, the blow is cushioned by the knowledge that their pensions have not dropped in value as well, and their ability to finance their retirement is unimpaired.

Good for society
As the pension plan fulfills its promises, the retiree population is more financially secure. Therefore, there is likely to be little or no need for social benefits to replace the loss of employee pensions.

Conclusion

Defined benefit plan sponsors have recently suffered from the asset liability mismatch risk. To address this, plan sponsors can make the liabilities (benefits) more like the assets or make the assets more like the liabilities. They can move to defined contribution plans, thereby making benefits like risky assets. A better option is to reduce risk taken by using more secure assets to make assets more like the secure benefits (liabilities). ◆