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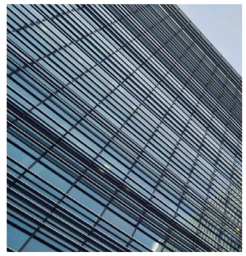
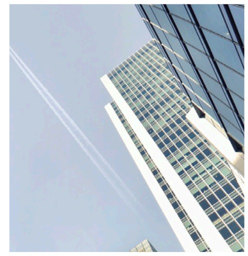
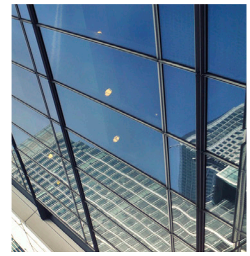
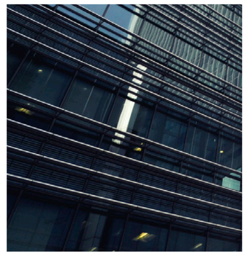

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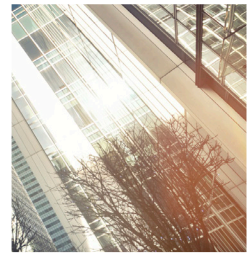

WORKFORCE MANAGEMENT ADVANTAGES OF DEFINED BENEFIT PLANS

By Victor Modugno

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During the great recession of 2007–09, there were stories of individuals delaying retirement because their 401k (DC) plan balances had been decimated by the decline in equity markets. Back when defined benefit (DB) plans ruled, the stock market had much less influence on retirement decisions. Indeed, early retirement incentives were used for workforce reduction which might be needed during a recession. The Pension Section commissioned a study in 2011 to determine if the replacement of DB plans with DC plans was impacting retirement savings and to quantify workforce management benefits of DB plans.

Between 1996 and 2010, at a time that the numbers of active private sector employees covered by DC plans increased by 59 percent while those in DB plans declined by 21 percent, assets in retirement plans in the United States increased 2.25 times—from 87 percent to 104 percent of GDP. This increase in assets can be misleading since two thirds of 401(k) plan contributions come from the employee while most DB plans are noncontributory. Due to higher annuity costs, the benefits provided by employer contributions declined slightly on a per participant inflation adjusted basis between 1996 and 2010.

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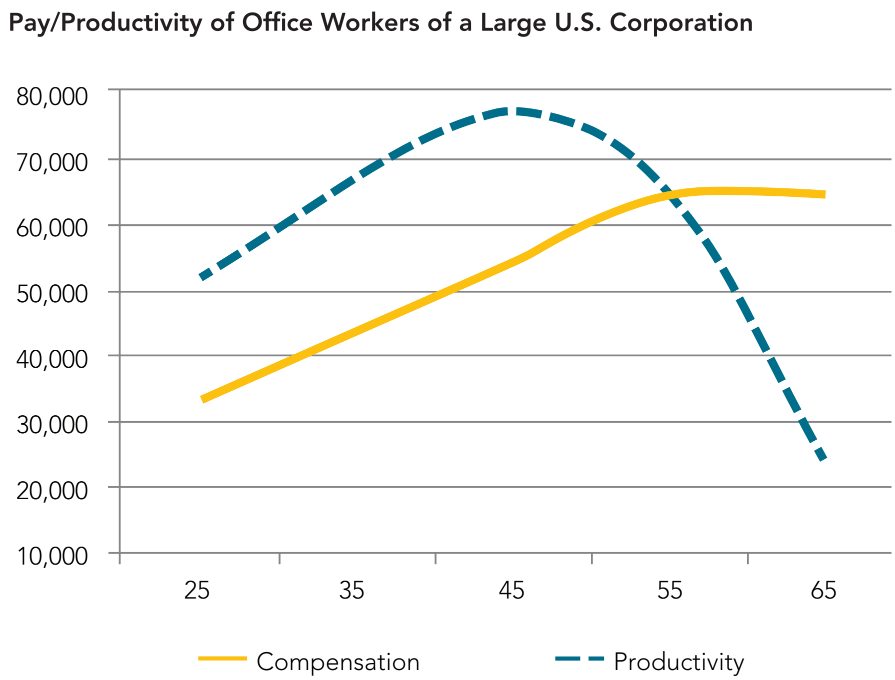
Many traditional DB plans have been converted to cash balance plans, which function more like DC plans. Most of this decline in DB plans is attributable to new companies adopting DC plans while employment at older companies with DB plans decreased. Countries such as the United Kingdom and Australia that switched to DC plans like the United States, showed more rapid increases in retirement plan savings compared to countries such as Canada and Japan, which remained with DB plans.

Studies using replacement ratios were reviewed along with data on sources of retirement income to conclude that over a quarter of employees may not be prepared for retirement at age 65, and over half may not be ready for retirement at age 55. Studies of employees' decision to retire were also reviewed. According to the National Institute on Aging/University of Michigan study, the trend to earlier retirement may be ending as baby boomers plan to work longer, employees with DB plans retire 1.3 years earlier than those with only DC plans, and poor health is more important than financial factors in deciding to retire early. According to the Transamerica Center for Retirement Studies, the retirement plan for many workers is not to retire. The percentage of workers who plan to work to age 70 (or not retire) is 39 percent, and 54 percent will continue to work after retirement with financial need being cited as the most common reason. Only 10 percent are very confident and 41 percent somewhat confident that they will be able to retire comfortably. The Society of Actuaries Risks and Process of Retirement Survey serves as another source for factors influencing retirement decisions. While only 11 percent of pre-retirees in the 2009 survey say that they plan to retire before age 60 and 59 percent plan to retire at 65 or later, of those actually retired, 51 percent retired prior to age 60 and only 18 percent retired at age 65 or later. In addition, 39 percent of retirees retired earlier than expected, with health and work related (layoff or firing) issues being the primary reasons for retirement. The study also shows that not all those whose retirement plan is to keep working will be able to do so, as two-thirds say they plan to work in retirement but only about one-third of retirees are actually working.

The quantifiable workforce management savings of DB plans primarily arises from the retirement of older workers whose productivity has declined but whose total compensation (including benefits) has not. An employee participating in a typical final pay DB plan accrues increasingly valuable benefits up to qualification for early retirement, after which the value of accruals decreases until they may be reduced or cease after normal retirement. While future income from a DC plan is dependent on account balances that rise and fall with the financial markets and annuity rates, income from a DB plan is known and not variable. When there is a recession and need to reduce staff, older employees under DC plans will not want to retire because their account balances are likely lower due to declines in investment markets. Employers who provide a DB plan can offer an early retirement window of enhanced benefits to encourage older employees to retire during recessionary times. Better employee morale and loyalty may be some of the less quantifiable benefits of DB plans.

A number of studies of pay and productivity were reviewed. The pay/productivity gap is illustrated from the Kotlikoff study in the chart on page 6.



ENDNOTES

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5 Kotlikoff , Laurence "Estimating the Age-Productivity Profile Using Lifetime Earnings" NBER Working Paper No. 2788 (December 1988) *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=447218*

6 Dostie , Benoit "Wages, Productivity and Aging" IZA Discussion Paper No. 2496 December 2006 *http://ftp.repec.iza.org/RePEc/Discussionpaper/dp2496.pdf* and van Ours, Jan C., Stoeldraijer, Lenny, "Age, Wage and Productivity" Forschungsinstitutzur Zukunft der Arbeit Feb 2010 *http://ftp.iza.org/dp4765.pdf*

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Using data from the Kotlikoff study on a sample group with five employees ages 25-65, the cost (compensation/productivity) of the 65 year old working an additional year because the DC plan does not provide sufficient benefits was 16 percent of payroll. Two other studies, with less dramatic pay/productivity gaps were also included with lower cost for the continuing employment of the 65 year old. In all cases, DB plans have significant cost savings from retirement of older workers.

Defined benefit plans have been used for workforce management—to encourage older workers to retire and provide early retirement incentives when staff reductions were needed. While defined contribution plans have led to an increase in retirement plan assets, their voluntary nature and lack of benefit certainty make them less effective for workforce management. Other potentially expensive methods of workforce management will be needed. Adjusting compensation down in line with reduced productivity through demotion or dismissal has legal and reputational risks. Offering cash severance for layoffs may be more expensive on an after tax basis than using DB plans. ■