SOCIETY OF ACTUARIES

Article from:

Pension Section News

June 2001 – Issue No. 46

PENSION SECTION NEWS

NUMBER 46 JUNE 2001

Chairperson's Corner

A Good Time To Be In The Pension Business?

by Bruce Cadenhead

A few years back, many of us were concerned that the defined benefit pension business was rapidly disappearing. Even though many of us have been very busy over the past few years, the trend away from defined benefit plans and toward defined contribution plans continues. But as the landscape continues to change, we may have some reason to be cautiously optimistic about the long-term future of defined benefit plans.

A number of trends are converging to enhance the prospect of defined benefit plans:

- As baby boomers approach retirement, retirement income and retirement security are getting more attention.
- Life expectancies are increasing. A much larger portion of our life will be spent in retirement.
- Plan terminations and the conversion of traditional defined benefit plans to cash balance plans have focused a lot of attention on defined benefit plans. This trend may enhance employee appreciation of the value of both traditional and hybrid defined benefit plans.
- Recent stock market performance points out the risk of relying too heavily on defined contribution (DC) plans for retirement security.

(continued on page 3)

Excerpts from the PBGC Actuarial Valuation Report — 2000 Fiscal Year

Editor's Note: The 2000 Annual Report of the PBGC and the complete 2000 Actuarial Valuation Report, including additional actuarial data tables, are available from Loretta Berg at the PBGC, (202) 326-4040, upon request.

The 2000 Annual Report of the Pension Benefit Guaranty Corporation (PBGC) contains a summary of the results of the September 30, 2000 actuarial valuation. The purpose of this separate Actuarial Valuation Report is to provide greater detail concerning the valuation of future benefits than is presented in PBGC's Annual Report.

Overview

The PBGC calculated and validated the present value of future benefits (PVFB) for both the single-employer and multi-employer programs and of non-recoverable financial assistance under the multi-employer program. For the single-employer program, the liability as of September 30, 2000, consisted of:

- $10.02 billion for the 2,864 plans that have terminated
- $2.75 billion for 10 probable terminations

Liabilities for "probable terminations" reflected reasonable estimates of the losses for plans that are likely to terminate in a future year. These estimated losses were based on conditions that existed as of PBGC's fiscal year-end. It is likely that one or more events subsequent to PBGC's fiscal year-end will occur, confirming the fact of the loss. In addition, the liability for reasonably possible terminations has been calculated and is discussed in Note 8 to the financial statements on page 38 of PBGC's 2000 Annual Report. A discussion of PBGC's potential claims and net financial condition over the next ten years is presented on pages 17-18 of that report.

(continued on page 4)

In This Issue

Excerpts from the PBGC Actuarial Valuation Report — 2000 Fiscal Year *by Joan M. Weiss* ... 1

Chairperson's Corner *by Bruce Cadenhead* ... 1

Articles Needed for the *News* ... 2

QDRO's With Fewer Hassles *by Mitchell I. Serota* ... 6

The Continuing Search for the "Ideal" Pension Funding *by Thomas R. Benzmiller, Jeffrey A. Rees, and Frank G. Burianek* ... 8

2001 Enrolled Actuaries Meeting - Multi-employer Plans Session and Workshop *by Pam Marlin* ... 13

Pension Forecasts, Part 2: The Model Has No Clothes *by Lawrence N. Bader* ... 14

Joint Meeting Committees on CRSR and CRSPED minutes ... 16

Announcement of New Web site *by Joint Board for Enrollment of Actuaries* ... 18

2001 Meeting Editors Wanted ... 19

Tax Bill Includes Pension Reforms ... 19

Continuing Education Update *by Barb Choyke* ... 20

Chairperson's Column
continued from page 1

There has been a lot of research recently on the financial needs of retirees. As an example, see the January 2001 issue of the *North American Actuarial Journal,* which focuses on the Retirement 2000 Symposium. These research activities on the role of defined benefit plans (or on annuity-type benefits) in enhancing retirement security.

It is in our best interest to work to improve the public's understanding of the value of annuity benefits in general, and defined benefit plans in particular. We should continue to sponsor research in this area, as well as continue to develop effective communication tools for defined benefit plan participants and other retirees. Better understanding should lead to better policy (as well as better employment prospects for actuaries). As the cash balance debate illustrates, our voices need to be heard in order to present a balanced (and better-informed) view of the issues.

I'd like to take this opportunity to raise some relevant issues. Some of these are the topic of recent research. These are not necessarily new ideas within the actuarial community, but may not be widely appreciated among the general public—in particular, plan participants and employers.

Employers' decisions to move away from defined benefit (DB) plans have been driven by a number of concerns. Among these are:

- A perception that employee appreciation of defined benefit plans is not commensurate with the cost of maintaining these plans. Many employers believe that their employees do not understand the value of the pension promise because the plans are too complicated.
- The lack of portability offered by DB plans limits their appreciation among younger employees.
- The disproportionate reward provided by DB plans for service during the years immediately preceding retirement.

The trend toward defined contribution and cash balance plans is largely a response to these concerns. In particular, there has been a perception that "value" is best expressed as a current lump sum, rather than as an annual retirement income equivalent. However, account-based plans also increase the risk of a mismatch between retirement savings and financial needs. Savings may fall short as a result of poor budgeting, inadequate returns on investments, or longevity (longevity should be a good thing, not a problem!). On the other hand, it is also possible that retirement savings will be more than adequate. But, since you can't take it with you, the benefits of having too much (being able to leave an inheritance) probably don't outweigh the cost of having too little. The number of people living into their 90s and 100s is increasing rapidly. Our quality of life during these years will depend, in part, on our financial resources. Annuities are particularly advantageous to those enjoying a long retirement.

Cash balance plans offer a potential advantage over DC plans in this area in that they must offer an annuity option. There is nothing to prevent a retiree from purchasing an annuity with DC assets. However, a cash balance plan may facilitate payment in annuity form by offering a favorable conversion basis — this is particularly true for women, since the plan's conversion basis must be unisex. In addition, some defined benefit plans now accept transfers from DC plans, giving DC participants the same annuity options that cash balance participants enjoy.

Currently the majority of cash balance and DC participants do not take advantage of the annuity option. The major impediments are probably a misjudging of the risk of financial ruin, and, to a lesser extent, the limited availability of inflation-indexed annuities. We find it easier to focus on, and insure against, near-term risks — the potential for loss due to fire, for example, is easy to understand, and could happen at any time. Compared to the risk of fire, the risk of future financial insolvency may appear remote and hard to quantify.

I am optimistic that we can improve public understanding of this issue. As public awareness increases, financial security should improve for retirees with account-based benefits, as more will elect to annuitize at least some portion of their benefits. At the same time, this type of public debate will shift the measure of a plan's value away from the lump-sum present value of the benefit, and toward the annual retirement annuity offered. Such a shift would enhance the viability of the traditional DB plan.

Improving public awareness of the value of defined benefit plans addresses the first of the employer concerns noted above. However, the other concerns remain. These issues point out some of the limitations of the traditional defined benefit plan. While some employees — those who have a long period of service with a single employer immediately prior to retirement — win big, other employees don't fare as well. In particular, employees with frequent career changes lose significant value because benefits with prior employers are not adjusted to reflect post-termination salary increases. Older retirees also lose out as purchasing power erodes due to inflation (unless benefits are indexed).

Bruce Cadenhead

One way to address these concerns would be to index benefits for inflation. Of course, simply adding a cost of living adjustment to an existing formula would greatly increase the cost. The rate of benefit accrual would have to be reduced for the change to be cost-neutral. (Such a change for an existing plan would, of course, raise significant transition issues.) By keeping benefits constant in real terms throughout a retiree's lifetime, income immediately after retirement would be lower, while income later in retirement would increase. If the plan extends inflation protection to the period between termination and retirement, then concerns about portability and disproportionate rewards for later years of service diminish. The career changer would be compensated for at least a portion of post-termination pay increases.

The close cousin to the fully indexed defined benefit plan is the cash balance plan. Both plans tend to deliver value more evenly throughout a career. The main difference is that with a cash balance plan, the focus is on the account balance, which is expressed as a lump sum. If the cash balance plan offers an indexed annuity option, and if retiree appreciation of annuities increases, then the line between the two types of DB plans blurs even further.

I present these thoughts not to advocate a particular type of defined benefit design, but to encourage discussion. The various retirement plan design options, ranging from the traditional defined benefit plan at one end of the spectrum, to the 401(k) plan at the other end, comprise a continuum. Indexed defined benefit plans and a cash balance plan with well-communicated annuity options are points on this continuum that are often overlooked. Improving the understanding of the relative benefits of different pension options is in our best interest as actuaries.

Conditions are ripe for a meaningful discussion about the role of defined benefit plans in providing financial security throughout retirement. Let's take advantage of this opportunity.

Bruce Cadenhead, FSA, MAAA, EA, is principal of William M. Mercer Inc. in New York, NY. He is Chairperson of the Pension Section Council and can be reached at Bruce.Cadenhead@us.wmmercer.com.