

Is There a Future for Defined Benefit Pensions in the United States?

by Julia Coronado and Gary Hewitt

Many analysts are concluding that the defined benefit (DB) pension system is on its last legs. In fact, the authors of this article argue that companies offering only defined contribution (DC) retirement packages have become dissatisfied on a number of levels and, as a result, are trying to make their DC-only plans look more like DB pensions. After providing an overview of retirement plan trends and the current environment in which plan sponsors operate, the authors survey over 500 companies over the period from 2000 to 2005. They find that many of the plan sponsors are deciding to stay with, or even expand, their DB plans.

There has been a veritable media frenzy surrounding the pension woes of a number of airlines and the resulting financial shortfall at the Pension Benefit Guaranty Corporation (PBGC). Taken together with recent evidence that the number of large defined benefit (DB) pension sponsors that have plans either frozen or closed to new hires has increased of late,¹ many analysts are concluding the DB pension system is on its last legs. Yet the rumors of the demise of the system may be premature. A number of employers have reevaluated the costs and benefits of these plans and are deciding to stay with them.

TRENDS IN PENSION COVERAGE

One of the most striking changes in the composition of household retirement savings over the past 25 years has been the shift from DB to defined contribution (DC) pension plans. As shown in Figure 1, while the share of full-time workers in the United States

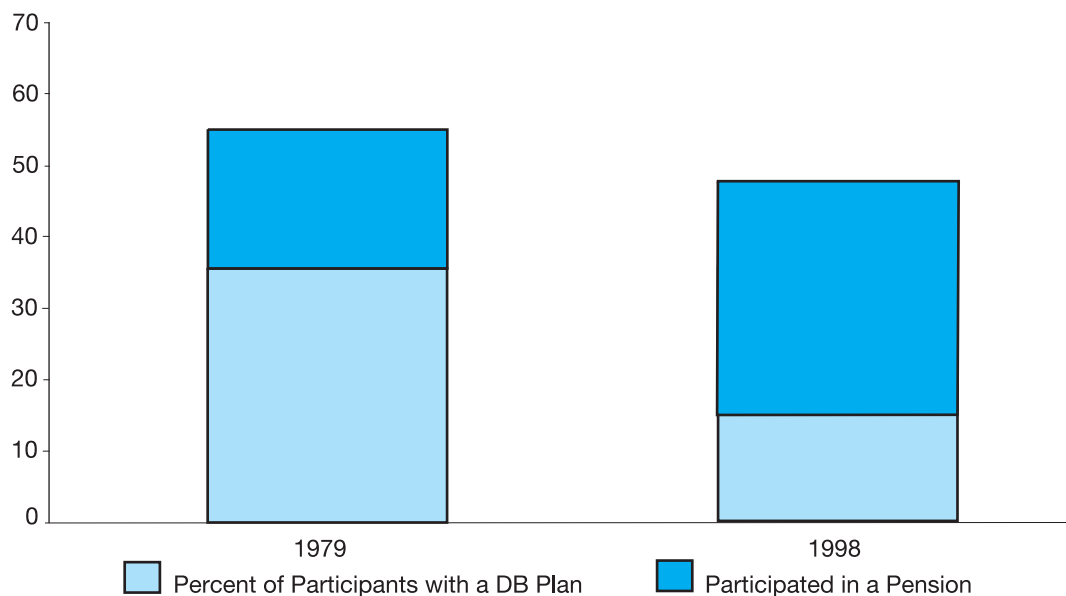
that participated in any pension plan (the height of the bars) edged down from around 55% in 1979 to less than 50% in 1998, the composition of pension coverage changed dramatically. The shaded portion of the bars shows that, while two-thirds of workers with pension coverage in 1979 had a DB plan, only a third had a DB plan in 1998.

In the first years following the clarification of 401(k) regulations in the early 1980s, DC plans served mainly as a supplement to DB pensions. Over time employers without DB pensions and start-up companies opted for a 401(k)-only retirement benefit, while smaller- and medium-sized ones with DB plans terminated their pensions in favor of DC packages. Larger employers that had DB plans in place in the 1970s have largely stuck to dual DB and DC coverage, although as start-up firms that opted for a DC-only approach have grown—and some of the older DB sponsors have gone out of business—those firms offering dual coverage have employed an increasingly smaller share of the workforce.

The Employee Retirement Income Security Act (ERISA) of 1974 was enacted at a time when DB

► **FIGURE 1**

PENSION PARTICIPATION AMONG FULL-TIME PRIVATE SECTOR WORKERS 1979-1998



Source: “Are Firms or Workers Behind the Shift Away from DB Pension Plans?” Stephanie Aaronson and Julia Coronado, Federal Reserve Board of Governors Finance and Economics Discussion Series Working Paper No. 2005-17.

pensions were the dominant form of employer-sponsored retirement benefit. The law sought to enhance the security of retirement benefits through the establishment of participation, vesting, funding, reporting and disclosure requirements for plan sponsors; the creation of a standards-setting body for actuaries; and the formation of the Pension Benefit Guaranty Corporation (PBGC) to insure accrued benefits in the event of the sponsor’s bankruptcy. Many observers have cited the increased costs of complying with the regulation as a key factor in the decision of many employers to move away from these plans. Since these compliance costs have a fixed element, they are less of a burden on larger employers that benefit from economies of scale and, hence, small and mid-sized companies have tended more to move away from DB sponsorship.

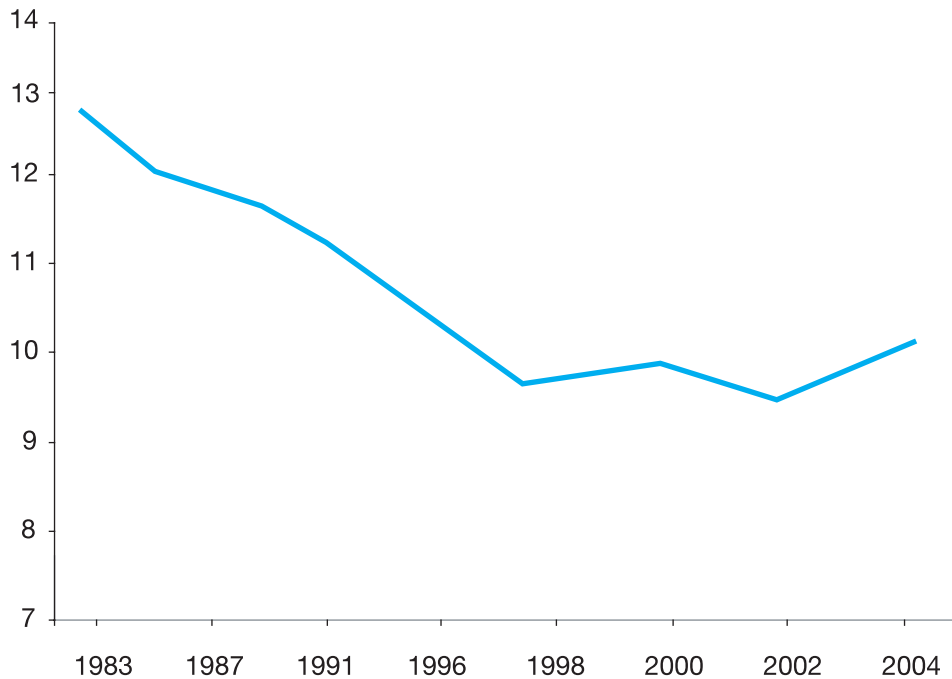
Yet other economic forces appear to have influenced the shift. Economic activity has shifted from manufacturing, where company-specific skills are important and DB pensions are commonly used to encourage retention up to a point and then to encourage retirement; toward the service sector, where

employee skills are perhaps more transferable across companies and DC-only coverage is more common. This shift in activity—combined with the influence of rapid advances in technology that have also led to the increased importance of skills that are not as particular to a company—has led to an increasingly mobile workforce. As shown in Figure 2, median tenure for men in their prime working years (ages 45-54) has declined 25% since 1983, from nearly 13 years to about 9½ years. The sea change of women entering the labor force in recent decades also appears to have influenced the demand for more portable benefits.² Women, and more generally dual earners, have to balance demands for home production with their labor supply choices and may have less attachment to either specific employers or the labor market more generally. Since benefits in traditional DB plans accrue most rapidly in the years just prior to retirement, these plans do not facilitate retirement saving among workers who change jobs several times over a career.

One development that highlights the importance of changing labor markets is the conversion of

► **FIGURE 2**

MEDIAN YEARS OF TENURE WITH CURRENT EMPLOYER FOR MEN AGES 45-54



Source: U.S. Bureau of Labor Statistics.

many traditional DB plans to cash balance or other hybrid plan designs. These conversions became popular in the 1990s, and currently roughly 25% of Fortune 1,000 DB sponsors have a *hybrid plan*. These plans are DB plans in which benefits accumulate in the form of a hypothetical account balance that is typically paid as a lump sum when the worker leaves the firm. Hence, these plans feature a more even rate of benefit accrual over a worker's tenure, and job mobility is not penalized. Since hybrid pensions are regulated as DB plans, their popularity does not stem primarily from avoidance of regulatory burden.

In addition to providing better retirement benefits for mobile workers, the hybrid conversion trend also results from several other influences on DB sponsors. The first, brought about by the increasing popularity of 401(k) plans, is the easier communication of these plans' worth to participants. Workers with 401(k) plans can easily understand the value of their retirement benefit, whereas the value of a traditional DB plan benefit is typically less well understood until close to retirement. Hybrid plans allow employers to

communicate DB benefits in comparable terms to a 401(k) plan, as an account balance, and report annual benefit accruals as well.

The second impetus for hybrid conversions comes from the aging of the workforce and related demographic pressures on employers. Most traditional DB plan designs include early retirement subsidies that provide an economic incentive for older workers to retire. As growth in the labor market slows, however, employers increasingly need to retain experienced workers. Most hybrid conversions eliminate early retirement subsidies, and often have features such as accruals that increase with tenure that encourage continued work at any age. Finally, the Omnibus Budget Reconciliation Act of 1987 limited the ability of firms to prefund benefits, making it difficult to manage the backloaded pension accruals typical to a traditional DB plan.³

THE CURRENT ENVIRONMENT

Perhaps owing to innovation in plan designs that allowed DB sponsors to meet their workforce man-

agement needs, as well as to favorable returns in financial markets, the rate of decline in DB coverage slowed in the late 1990s. While the number of small plans continued to decline, the number of large plans actually increased.⁴ Since 2000, however, plan sponsors have faced a series of challenges that threaten to weaken the DB pension system. The first of these is often referred to as the “perfect storm,” the combination of falling equity prices that dealt a blow to pension asset values and falling interest rates that pushed up current value measures of liabilities. These conditions took plans from a peak average funding ratio of 122% in 1999 to a trough of 76% in 2002. Since then, firms have regained some lost ground with an average funding ratio of 83% at the end of fiscal year 2004. While many sponsors ran up against Internal Revenue Service contribution limits and had to stop contributing to their plans in the late 1990s, these same firms found themselves in double jeopardy in recent years: facing both pension shortfalls and challenges in their core business at the same time.

In addition to the financial challenges, firms face a number of uncertainties from federal regulation. In the United States, cash balance plans have seen a number of high-profile court cases in which plan participants claimed age discrimination, and the resulting rulings have left these plan designs in legal limbo. Congress has, to date, not been able to clarify the legality of the cash balance plan design. In addition, the collapse of a number of large plan sponsors in the steel and airline industries in recent years has left the Pension Benefit Guaranty Corporation facing the largest funding shortfall in its history. As a result, current legislative proposals are proposing stricter funding requirements and higher PBGC premiums for all plan sponsors. The number of large DB sponsors with a frozen or terminated plan rose last year, and a number of companies have closed their DB plans to new hires and adopted a DC-only structure for retirement benefits going forward.⁵

While sponsors of DB pensions are facing these financial and regulatory challenges, firms with only DC pensions are increasingly facing their own set of problems. The overwhelming majority of DC plan designs require employees to make voluntary contributions out of their cash compensation before the employer matches contributions. As a result, participation rates in DC plans have been disappointing. The participation rate among all workers is about 75%, but lower income and younger workers have substantially lower participation rates.⁶ Among those who do participate in their 401(k)s, there is a concern that participants are not contributing enough to secure their retire-

ment, and that they make suboptimal investment choices.

DEFINED BENEFIT VS. DEFINED CONTRIBUTION: WHAT ARE THE REAL DIFFERENCES?

In light of the emergence of hybrid DB plans that offer portability and more front-loaded benefit accrual, the differences between the DB and DC retirement models have become less pronounced. Yet some fundamental distinctions remain. In contrast to DC pensions, in DB plans, the employer makes the saving decision. The employer decides who participates, what contributions are made to the retirement plan and how plan assets are invested. These features allow employers to target particular levels of retirement saving for their employees, and that amount of saving accumulation will not be affected by inertia and procrastination.

The employer also bears the investment risk in a DB plan, which can translate into volatility in costs. While long-term plan expense is fairly well known, it can fluctuate year over year, and this volatility can pose a risk to a firm’s ability to manage its core operations through business cycles. Consequently, plan sponsors have been given a degree of flexibility in funding requirements under ERISA to help them manage the volatility and smooth through economic fluctuations by contributing more in good times and less in lean times. Yet the degree of flexibility is far from perfect. Sponsors are restricted in their ability to overfund their plans in good times so that extreme down markets, such as those of 2000 through 2002, hit employers’ funding positions hard and lead to large required cash infusions. The retirement saving of employees does not fluctuate in tandem with business conditions. In firms with DC-only plans, the retirement saving of employees absorbs the volatility. Since asset prices often move with business conditions, employees can experience a hit to their retirement saving precisely when their employer is experiencing weak revenues. Indeed, many employees in DC-only firms were hit with a double whammy in the last market downturn as many employers cut back or suspended their 401(k) match owing to weak cash flow. The fact that business conditions move in concert with the retirement saving of employees can potentially lead to difficult workforce management situations should the employer need to cut back its workforce at a time when older employees are unable to retire.

The benefit of assuming investment risk in a DB plan is that, as manager of a large pool of assets, a DB

sponsor can potentially achieve superior investment performance. Evidence suggests that DB plans engage in more portfolio rebalancing and have achieved higher returns on average.⁷ Sponsors of DB plans are required to offer retirement benefits as an annuity, shielding participants who choose this option from longevity and investment risk after retirement.

From a workforce management perspective, DB plans provide different incentives for employees and achieve different workforce goals, encouraging retention of employees both early and late in careers, with near-universal five-year vesting provisions and higher accrual rates for older workers. DB plans also provide a significant degree of design flexibility—for example, design options include early retirement subsidies or phased retirement incentives, Social Security integration and retention bonuses—that allow employers to manage workforce retirement and retention behavior. While DC vesting schedules offer some early-career retention incentives, fewer design variations are available for employer contributions due to regulations intended to balance participation among employees at different compensation levels. Indeed, survey data show that DB plans have more powerful effect on attraction and retention, particularly among older employees.⁸ This may become an increasingly attractive feature of DB pensions to employers as the workforce ages and the growth in the labor force slows.

LOOKING AHEAD: IS THERE A FUTURE FOR DB PENSIONS?

The end of the DB pension system is far from certain. Most companies have or are in the process of evaluating their retirement benefit programs, and many sponsors are in fact deciding to stay with their DB plans. We surveyed the retirement plan provisions of a sample of over 500 DB sponsors over a six-year period between 2000 and 2005 and found that two-thirds did not change the basic DB/DC structure of their retirement plans for new hires. A significant number (17%) froze or closed their DB plan and adopted a DC-only package; but a number of companies (9%) actually added DB plans or expanded coverage during this six-year period—a period that coincides with many of the significant regulatory and market challenges to the DB system described above.⁹

We interviewed a number of companies that decided to stay with or expand their DB programs and several recurring themes were revealed:

- Nontraditional hybrid plan designs are important in companies' decisions to retain and expand DB coverage.

- The workforce goals of attraction, retention and the management of retirement behavior are fundamental to the decision to stay with DB pensions.
- Corporate change, notably mergers, frequently plays an important role in triggering expansions of DB coverage.
- Companies that retain or expand their DB plans almost always do so within the context of a retirement package that also includes a DC savings plan.
- Finally, DB plan sponsors understand that they are incurring a degree of risk in providing DB benefits and need to be able to stand short-term funding requirements in exchange for the longer term benefits of lower expected costs and workforce goals afforded by the DB designs.

Three case studies illustrate these themes in action.

CASE STUDY ONE: OPENING A CLOSED PLAN

The Aerospace Corporation, a midsized federally funded research and development center, closed its hybrid DB plan to new entrants during the recession of 1991-1992 and replaced it with a generous DC plan. The 1992 decision was driven by a desire to provide a portable benefit and to follow what was seen as a general trend toward DC retirement plans. A decade later, a number of issues came together that led Aerospace to revisit its retirement programs. It had become unclear that the DC-only plan supported the company's overall workforce goals. Aerospace has a highly skilled workforce, where long employee tenure is a key part of the overall human resources (HR) strategy. While the company believed that a DC plan was important to attracting new talent, its portability did not align with the overall goal of retaining

► THE AUTHORS

Julia Coronado is a senior research associate at Watson Wyatt and leads the retirement research program in Watson Wyatt's Research and Information Center. She has written extensively on issues related to pension structure, pension finance and Social Security and holds a Ph.D. in economics.

Gary Hewitt is a research associate in Watson Wyatt's Research and Information Center. He directs Watson Wyatt's Client Research Institute and holds a Ph.D. in history.

employees. The company has a vibrant phased retirement program and also employs a number of full-time employees well into their 70s and 80s.

Aerospace also did not like having two different plans for pre-1992 and post-1992 hires, and having two plans also contributed to potential nondiscrimination testing problems in the DC plan. After examining a series of options, including dropping the DB plan entirely, Aerospace came to a creative solution: Cut each of the existing retirement programs (the pre-1992 DB plan and the post-1992 DC plan) in half and combine them into a single DB/DC retirement program.

The resulting plan is both complex and competitive. The DB plan is a combination of a Social Security-integrated and inflation-indexed hybrid plan with a hybrid variable benefit plan. To simplify communicating the value of the DB plan, its benefit is expressed as annual accruals in the guaranteed and vari-

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able benefit balances. The company was comfortable with providing such a complex benefit, largely because its workforce is composed of highly educated engineers and scientists. Aerospace also provides an online modeling tool that combines DB and DC accruals and provides an annuity-value estimate for each component, and allows employees to change assumptions about rates of return, salary increases and retirement age. On the DC side, the plan has a significant employer contribution of 4% of salary. The company also provides age-based life cycle funds as the default investment option, and nearly two-thirds of plan assets are invested in the default life cycle fund.

The driving force behind this decision was a desire to match the retirement plan to the overall HR strategy: Attract the best and brightest with competitive benefits, reward them with the tax-advantaged sav-

ings vehicle and retain them with a retirement plan that encourages long service (as part of the plan redesign, an early retirement subsidy was removed). The company determined that the combination of a hybrid DB plan with a DC plan best met this goal.

CASE STUDY TWO: EXPANDING A DB PLAN TO AN ACQUIRED COMPANY

A food processing company in the midst of a merger faced the question of what benefit plans to provide to the salaried employees of the new, merged firm. The acquiring company had a cash balance DB plan for its salaried employees, along with a DC plan, while the acquired firm had a fairly generous DC-only retirement plan. The business strategy for the merger was complete integration and harmonization of the two firms, including employee benefits. As a result, the firm needed to decide whether to choose a DC-only plan or to expand the DB plan to cover the acquired employees.

A number of factors drove the company's decision-making process. First was a desire to compete effectively for talent in the food processing industry. DB plans were common in the industry, and the company decided that moving away from a DB plan arrangement would put it at a competitive disadvantage in attracting managerial talent. The second factor was a desire on the part of the company to insulate at least some of employees' retirement income from market risk. The DB plan structure ensured that at least a piece of a pie was protected. Finally, the company believed that it could provide better benefits at a lower long-term cost through the DB plan, where returns on the fund's investments would offset some of the costs.

The company chose to modify and expand its cash balance DB plan to cover all employees of the combined firm. In general, contribution levels were enhanced from the old acquiring company's plan to match the age-based contribution schedule of the acquired company's DC plan. This ensured that the employees of the acquired company did not give up benefits as a result of the merger. The DC plan was converted to a program where the employer matched 50% of employee contributions up to 6% of salary with a two-year vesting period.

CASE STUDY THREE: OPENING A NEW DB PLAN

A large health care network with over 8,000 employees faced some of the workforce challenges typical to health care providers: foremost among these,

an aging population of critical skill nursing staff and a limited pipeline of recruits. The combination of needs led this organization to examine the role of retirement benefits in attracting and retaining employees.

The organization decided to implement a new retirement plan in 2003 that combined a new DB and a DC plan. The organization sought to enhance its long-term retention incentives by providing a career average DB plan, while also providing an employer match on the DC side that would attract employees in a highly competitive labor market. Its package was also designed to be better aligned with the retirement packages being offered by competitors.

Two key workforce philosophies structured this decision. First, the company saw the retirement plan within a total compensation framework. This organization wanted to ensure that the entire compensation package, including benefits, offered an appropriate mix of cash and noncash remuneration. Second, the company wanted to find an optimal way of delivering this compensation within the constraints of the compensation and benefits budgets. A combination of DB and DC retirement plans emerged as the best solution for this organization.

CONCLUSIONS

Companies that offer DC-only retirement packages have become dissatisfied with these plans on a number of levels. As a result, Congress is currently developing proposals to make it easier for employers to offer features such as automatic enrollment, automatic default investments into funds that shift out of equity as a worker ages, escalating contributions and default annuitization options upon retirement. In other words, DC sponsors are trying to make their plans look more like DB pensions. Companies that offer a dual retirement package with a DC plan (that appeals to younger and more mobile workers) with a DB package (that facilitates stable accumulation of retirement saving and is more appealing to older workers) may find themselves at a competitive advantage, and a number of companies have come to that conclusion. The DB plans that were designed to encourage the retirement of older workers in years past are now being turned around to encourage the continued labor force participation among older workers through design features like phased retirement options and increasing accruals.

The financial market fluctuations of recent years have been a trial by fire for most DB sponsors as they were forced to come to grips with the risk in their pension portfolios. While some have responded by getting rid of their DB plans, others have recognized the benefits of these plans and turned to emerging tools for managing portfolio risk through asset/liability matching and hedging strategies.

The features that employers appreciate about DB plans, namely, that they facilitate the stable accumulation of retirement saving and productive employment relationships, should also appeal to policy makers. It is notable that many of those who stayed with their DB plans have converted their traditional plan designs to hybrid designs. This highlights the importance of clarifying the legal status of hybrid pensions. Furthermore, while it is essential that PBGC be allowed to limit its risk exposure, profitable plan sponsors should be given the flexibility to overfund their plans in good times to manage the volatility that comes with investing in financial markets. A system of retirement saving that facilitates the pooling of investment risk across time and across groups of workers can lead to efficiencies in retirement saving. ◀

Endnotes

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