Since the “Great Recession” ended in 2008, many defined benefit (DB) plan sponsors have taken advantage of legislative acts aimed at providing relief from surging contribution requirements. The most prominent of these acts being the Moving Ahead for Progress in the 21st Century Act (MAP-21), which was signed into law in 2012. MAP-21 established an interest rate corridor enabling plan actuaries to discount liabilities at substantially higher rates and thereby lowering plan liabilities used to determine annual contribution requirements. The MAP-21 overrides make it perversely appear that a plan is well-funded, when in fact most are not. Without the interest rate construct of MAP-21, plan sponsors would have been forced to measure liabilities at near market rates, which, due to Federal Reserve policies, have been suppressed in order to spur economic activity post-recession.

In 2012, the hope was that rates would rise as the economy rebounded; however, four years later, yields remain stubbornly low, due to investors seeking the relative safety of fixed income investments.

Due to the MAP-21 corridor, rates used to determine plan liabilities and their corresponding contribution requirements have been decreasing by about 20 to 30 basis points per year, which in turn has led to higher liability valuations. This pattern is likely to hold until 2020, enabling actuaries to determine the discount rates used to measure future plan liabilities with unprecedented accuracy and leaving asset returns as the remaining significant variable in determining future contribution requirements.

As plan liabilities are projected to steadily rise, funding levels will decrease, unless assets over-perform. Combined with the potential for a down year in asset returns, many plan sponsors may once again face the specter of substantial increases in upcoming contribution requirements. Plan sponsors who have yet to pull the trigger and transition into a defined contribution (DC) plan should look closely at their options. Higher contribution requirements, along with large increases in PBGC premiums, will add mounting pressure for organizations to migrate towards defined contribution style plans, further dwindling the shrinking DB universe.

While some plan sponsors may falsely believe that transitioning to a DC program is a routine
administrative process, finding a commensurate DC plan and further communicating the change to affected employees is a delicate, and at times difficult, matter. Transitioning from a DB- to a DC-style plan requires significant work and a number of tough decisions along the way.

REALITY CHECK

Have you ever seen a certain reality TV show where a real estate agent prompts first-time home buyers for a list of their “must-haves” and budget? The agent then spirits them off to a beautiful home that meets all of their requirements and needs, with the exception of the asking price. Hopes are dashed, even though it is likely that anyone appearing knows they are being set up for disappointment.

We find that nearly half of the DB to DC transition studies have been attempted previously by the organization. Why have they failed in the past?

The short answer is unrealistic expectations. Expectations make it difficult for decision makers to reach a consensus, ultimately crippling any chance of progress unless they are reset. Additionally, change is disruptive. Overhauling a retirement program takes thoughtful consideration and time. A successful transition requires making tough decisions that directly affect employees and their future security. Unfortunately, there is no panacea.

We find that the two most common stumbling blocks to a successful transition are:

1. Accepting that there will be winners and losers, and that the losers will overwhelmingly be older employees with longer tenure
2. The expectation that the organization will begin saving money right away

The truth is that a DC plan cannot replicate the same level of benefits for all employees under an existing DB plan. As older employees near retirement and grow closer to receiving benefit distributions from the plan, their liability and corresponding cost to the employer increases significantly. DB plans attribute more of the employer’s contribution to older employees who represent a larger share of the plan’s liability, than similarly situated younger employees who have the benefit of time and compounding on their side. Conversely, the cost of a 25-year-old employee who is 30 to 40 years away from collecting benefits is minimal. Allocating such a large proportion of benefits to older employees in a DC plan is generally not allowed due to the nondiscrimination rules set forth by the IRS. Although some disparity is allowed, it is not enough to overcome the “value of youth”.

VALUE OF YOUTH:

At an interest rate of 6%, every dollar given to a 25-year-old is worth more than $10 at a retirement age of 65 versus $1.80 for that same dollar given to a 55-year-old.

Because the DC plan is unable to replicate the value of benefits earned under the outgoing DB plan, transitioning to a DC style plan is typically beneficial for younger employees and painful for older employees. The break point is different for each organization and depends on a number of factors and assumptions, such as the structure of the new DC plan, the benefit formula of the outgoing DB plan, and the assumed rate of return generating earnings under the DC plan.
It can be a bitter pill that is made all the more sour when plan sponsors realize that in addition to upsetting a portion of employees, the transition may likely cost more in the interim. In general, this is the reality for plan sponsors who must maintain and continue funding a frozen DB plan, while also instituting the new DC program. Most sponsors looking to eliminate their DB plan are doing so because of the higher costs and increased volatility they have faced during the past decade. However, unless the DB plan is fully funded or the organization has sufficient assets to settle their obligation, higher costs while maintaining both programs may be a likely scenario.

A good process for many sponsors to take is to step back and ask, “Why are we doing this?” If the driving force is to reduce costs, more often than not a more efficient solution may be found by amending the plan to reduce the level of benefits currently provided. Volatility can be effectively managed by changing the asset portfolio to mirror the performance of the underlying plan liability by investing in fixed income. Although this may lower actual returns, and therefore increase costs, it can be coupled with a reduction in future benefit accruals to produce a plan that is less expensive and easier to manage moving forward.

On the other hand, cost should be only one of the determining factors and many plan sponsors will move forward with the transition. Traditional DB plans will never match the flexibility and cost stability offered by DC plans. Note, however, the trade-off is that the investment risk previously borne by the employer is instead transferred to the participants, many of whom will unlikely match the performance of professional asset managers employed by the DB plan, or may not have the requisite knowledge to prudently manage their assets.

Unrealistic expectations present the biggest up-front hurdle to plan sponsors, but there are other challenges that can derail the process, including: how to quantify and measure the effect on employees, how to mitigate the impact on employees nearing retirement, how to communicate the changes to employees, and most importantly, how much the plan sponsor can afford on an ongoing annual basis.

The key to moving forward with a successful transition is an understanding that there is no perfect solution; however there can be a good one - and it starts with defining a budget.

Stay tuned for Part II of the “Transitioning from a Defined Benefit to a Defined Contribution Program” series - The Migration Study.