DEFINED BENEFITS REDEFINED

by David Howe (Canada)

It appears that the conventional defined benefit plan is under attack in most parts of the world. Whether the politicians and bureaucrats really appreciate that this is the result of their actions is, of course, another question. (Most of them have very generous defined benefits!) This paper identifies some of the actions and trends which in my view lead to the need to rethink the historic approach. The defined benefit approach still has much to recommend it and this is an opportunity for the profession to develop new ideas.

I should stress that I am not an international expert. Therefore, I thank my colleagues for confirming what is correct and personally accept responsibility for errors and omissions.

THE LEGISLATIVE ENVIRONMENT

The legislative and social environment which is encouraging the trend toward defined contribution plans includes the following:

Larger Allowable Defined Contributions

Draft Canadian legislation provides for a tripling of the maximum allowable contributions to defined contribution and individual retirement plans while holding steady the maximum benefit entitlement from defined benefit plans. These maximum benefits have, in fact, remained unaltered since 1976 with inflation inevitably creating an enormous erosion in their real value. While increasing the maximum contributions allowable to defined contribution plans, the Government of Canada is reducing the percentage of earnings which may be annually contributed to such plans from 20% to 18%.

In the United Kingdom, the 1985 Income Tax Act introduced the concept of personal pensions and was clearly predicated on a political desire to promote this type of arrangement. The Economist Magazine, amongst others, appears to support the superiority of capital accumulation plans over the traditional defined benefit arrangement. The 1989 U.K. budget substantially raised the allowable contributions to the personal pension plan.

The introduction of 401k plans in the U.S. gave impetus to what is equivalent to a defined contribution pension plan. However, with the passage of time, evermore stringent limitations on the amounts that may be set aside have eroded this initiative.

Ever Lower Maximum Benefits

As stated, Canada's maximum benefit from defined benefit plans has been frozen since 1976. On the other hand, in the United States the maximum benefit was actually reduced from $125,000 to $90,000 per annum in 1983. There is now substantial political support for a further lowering of this maximum. Although maximum formulas were applicable in the U.K. there was no limit upon which those formulas could be applied until 1988 when a £60,000 per annum earnings cap was applied.

It might, of course, be argued that maximums of this nature have little effect since they apply to so few senior executives. However, it is the senior executives who generally decide on the fundamentals of corporate pension plan design. A number of executives and pension experts are beginning to question the validity of including highly paid people in a funded pension plan which can only secure a benefit of a small proportion of their retirement income. Might they not be better taking a chance on an unfunded promise from their employer in return for being able to maximize their own savings through a personal pension arrangement?

Mandatory Indexing

Germany would appear to be the most "advanced" jurisdiction concerning itself with inflation protection. Legislation requires the periodic review of pensions in payment and adjustment to reflect increases in cost of living. In Canada, the Ontario government has proposed legislation requiring the provision of mandatory indexing for a portion of the increases in the Consumer Price Index. However, although this provision is mandatory for defined benefit plans, the retiree from the defined contribution plan will have the option of taking a level or indexed pension. There seems little doubt that legislation of this nature will be passed in Ontario and will eventually be extended to other provinces.

Legislation in the U.K. only applies to benefits which are provided to early leavers in lieu of social security and then only during the deferred period. However, a recent study by the Occupational Pensions Board has suggested the extension of indexing to all benefits earned by

early leavers and a requirement to offer to retirees the alternatives of a reduced indexed or full unindexed pension. The report went on to suggest employers should consider offering a promise of limited inflation protection but that the proposal should not be a legislated minimum. One might, however, question whether politicians can, in such populist times, resist for long the temptation to legislate.

Commutation of Benefits and Portability to Personal Plans

Canadian provincial legislation requires that individuals leaving prior to entitlement to an immediate pension can transfer the commuted value of their accrued benefit to their personal arrangements. This legislation was clearly designed to promote portability. The legislation also allows, but does not require, employers to offer such a transfer when a terminating employee can get an immediate pension. Australia, the U.K. and the U.S. all have similar legislation but their background would appear to be different in that it is not so much designed to encourage such transfers as to enable them. The long term effect, however, is not necessarily different.

The transfer of a lump sum to a personal pension arrangement has a lot of attractions to both parties. The member sees a substantial sum which he can now manage -- an attractive prospect in an environment which has seen such excellent investment returns in the last few years. The employer, by making the transfer, either avoids the potential liability imposed by future indexing legislation or at least has the benefit of capitalizing at that point in time the absolute value of such a guaranty.

Surplus Rights

In North America it has generally been presumed that the funds set aside in pension plans are assets in support of the employers' guaranty; thus, if the assets fall short the employer will make it up and if they are too much the employer can get the excess back. This position has been undermined in Canada by various Court decisions. Proposed legislation now implies that the surplus is only the employers if indexing is provided for all accrued benefits.

In the U.S., this issue is also gaining much prominence among the legislators. There are proposals that surplus returns on termination of plans should only be made after some supplements have been paid to members and substantial fees have been paid to the government -- the latter, even if no surplus exists.

The U.K. has appeared to attack the issue from the opposite direction in that the Chancellor felt that unnecessary funds were being set aside with substantial tax deferral impact. The report by the O.P.B. mentioned earlier also suggested that on plan wind up surplus should be used to provide post-retirement indexing.

THE MEMBERS AND EMPLOYERS PERSPECTIVE

When members see government restricting the defined benefit plan while promoting defined contribution, it is hardly surprising that the latter is gaining public popularity. Added to this is the employers "greed" in demanding ownership of all surplus and the oft quoted inadequacy of private plans in not providing inflation protection. All this at a time of high real rates of return and rising stock markets.

At the same time employers are hearing these arguments from their more vocal employees, they are:

- drowning in administrative complexity and expense;
- concerned over what obligations will be imposed on them by new legislation and what those obligations may cost;
- apprehensive about the costs of indexing -- a commitment which extends beyond the working lifetime of their employees and possibly the existence of their own organization;
- surprised by the degree of cost and contribution volatility that new accounting rules have caused and how indexing may result in even greater volatility.

To reconcile these concerns with a real desire to provide adequate security for employees, requires a rethinking of the defined benefit plan and its management.

SOME ALTERNATIVE APPROACHES

The alternatives outlined below assume that the employer is prepared to give up his traditional absolute (at least in North America) control over the pension plan, pension fund and plan design. This is because in varying degrees some of the risk is being shifted from the employer to the employees. The solutions must also control administrative costs directly or indirectly and reduce contribution and expense volatility. Achieve these objectives and the defined benefit plan will be back in business.

Money Purchase With a Defined Benefit Minimum (Floor Plan)

There are a number of Canadian plans of this type in operation and they are popular within the University community. The plan is composed of two parts. One is a money purchase accumulation of contributions by employers and, possibly employees, which is used on termination or retirement to provide retirement income. Employees may elect to direct their own investments or alternatively this can be done by a joint board of members and plan sponsors.

The second part of the plan provides a minimum benefit on retirement based on final earnings from a supplementary fund. This minimum may also apply on termination or early retirement and other supplementary benefits can be provided such as on early retirement or death.

Some have argued that this plan provides the best of all worlds to the employees and the worst to the employer and this can certainly be the case. Provided the supplements are chosen at an appropriate level and carefully managed, experience has shown it is possible to provide stable levels of employer contributions over a long period of time.

Many of the objectives outlined above can be achieved if the employer contributions to the supplementary fund are capped as a percentage of payroll at the outset and all administrative expenses are met from the plan assets. In return, employee representatives would expect to participate in the management of the plan.

The final average minimum condition allows for more aggressive investment of the money purchase element. Experience has shown in North America that members, left to choose their own investments, invest heavily in fixed interest vehicles when all the historical data indicates that for a long term investment of this nature a substantial portion invested in equities is appropriate. This approach, therefore, encourages the maximum benefit to be derived from a given employer cost.

Shared Cost Alternatives

This approach in its purest form is probably only appropriate for a large employer with a cohesive work force, e.g. a single union.

Member benefits are of the classic kind based on final earnings. The added variable in this case is the member contribution. A prerequisite to adopting this alternative is that member contributions to pension plans are practical, e.g. are tax deductible.

In its simplest form a comparison is made at each valuation of the present value of all future benefits to existing members less the assets on hand. The balance of the liability is expressed as a contribution rate over the remaining working life of the present active members. This amounts to the aggregate cost method.

Although the approach sounds simple, there are two or three practical problems. First, local legislation may impose certain minimum funding standards. Failure to meet them may create problems in the management of the process. Secondly, it would be nice to avoid constant changes in contribution rates by the members. Establishing corridors or contingency reserves might help in this regard. Finally, the problem is just how volatile will these contribution rates be. If the plan incorporates indexing for post-retirement benefits and the plan is relatively mature, short periods of high inflation could wreak havoc with the contribution rate. It may, therefore, be necessary to impose limits on the inflation protection element of the program and/or the basic benefit in order to ensure that contribution rates don't go beyond the willingness of employees to pay.

SUMMARY

The growth of employer funded defined benefit plans was a feature of the middle years of this century. Fifteen years ago, their demise was foreseen because of rampant inflation and poor investment returns. Now they are threatened by stability and high real rates of return. Some argue that the wheel of fortune will turn again but the present environment has gone on long enough to mean that simply defending the status quo is inadequate. Now is the time to develop approaches which will maintain the beneficial aspects of defined benefit plans while meeting the objectives of both members and employers.