Pension plans are by nature uncertain—and business hates uncertainty. No corporation likes to see its cash flow and profitability at the mercy of the stock market, interest rates, mortality and employee turnover, which are the variables that shape defined benefit (DB) plan funding.

Yet despite the uncertainty and hassles, DBs were corporate America’s clear retirement vehicle of choice from the establishment of the first private sector retirement plan in 1875 through the early days of ERISA. In 1980, almost two-thirds of retirement plan contributions were being channeled into DB plans. Most employers recognized that their workers were better off financially with a DB, which does not require the discipline to save a portion of each paycheck or the hassles and risks of managing one’s own retirement fund. A pre-set monthly pension also provided some protection to retirees against the risk of out-living their savings.

Then the tide turned. Over the next two decades, the proportion of workers covered by DB plans began to shrink by nearly 1 percent annually. Today, only about 15 percent of workers are covered by pension plans and the number of plans insured by the PBGC is down 70 percent from its peak. If this trend continues, the pension plan would seem to be headed for extinction.

DB’s prominent place on the three legged retirement stool has largely been taken by the defined contribution (DC) plan. After growing at an annual clip of 7 percent over the past 20 years, DCs are now the sole employer-provided retirement vehicle for more than 60 percent of workers who participate in a plan. The advent of the 401k plan in 1978 and a dramatic increase in workplace mobility are often cited as the central factors for the upsurge of interest in DC plans. A new generation of employees also is said to prefer the control, portability and simplicity of a DC plan. From an employer’s perspective, DCs offer the triple advantages of predictable costs, the flexibility to vary contributions based on business conditions and the transfer of investment responsibility (and the attendant risk) to employees. DCs also are easier to explain to workers, as well as generally being cheaper and easier to administer. DCs, some have said, are the retirement vehicle of the future.

I disagree. Most workers, provided with even a basic education in retirement planning, can appreciate the advantages of putting their employer in charge of a significant portion of their retirement income through a DB. In fact, when employees of the state of Florida were given the choice earlier this year of opting out of the state-run pension plan and putting their money into a new DC plan, they overwhelmingly chose to stay in the DB. Their choice probably was fueled in part by the prolonged stock market slump, during which many badly burned employees discovered to their chagrin that they lack the time, expertise and stomach for handling their own investments.

But Florida’s decision to offer employees a choice was unusual. Typically, employers decide what type of company retirement program to offer --
and over the last twenty years, they overwhelmingly have chosen DCs over pension plans. Why?

Overregulation is the culprit. Congress, the PBGC, IRS, DOL, and virtually every other agency that has a say in the way retirement plans are administered or reported to shareholders have created a huge regulatory burden that has tipped the scales in favor of DCs. For most employers, DBs simply are no longer worth the added effort or financial risk.

First on the list are the Goldilocks funding rules, which punish employers whose plans are not funded “just right.” In 1986 and again in 1990, Congress virtually closed the door on an employer’s ability to recapture excess pension assets. User-friendly IRS rulings once allowed employers to withdraw excess assets, while continuing the plan through a spin-off termination. No more. Internal Revenue Code Section 4980 imposes a draconian 50 percent excise tax on a plan reversion (reduced to 20 percent, if benefits are increased or enough of the excess is transferred to a replacement plan).

While employers cannot reap the rewards of an over-funded plan, they are severely punished for maintaining an under-funded one. Since 1987, an employer whose pension funding dips below 80 percent in one year, or below 90 percent for two out of three years, generally is required to amortize the shortfall over five years or less. Even worse, if vested liabilities exceed assets, the employer is socked with an additional PBGC premium equal to almost 1 percent of the difference. This added premium—paid to the Government and not the plan—is simply money down the drain. Employers may be further punished by the imposition of additional reporting obligations and faster contribution schedules.

To exacerbate the situation, plan liabilities for purposes of the additional funding obligation and PBGC premium surcharge are calculated using unrealistically low interest rates tied to U.S. Treasury rates. The lower the rate, the higher the liability. While Congress recently did grant some interest rate relief, employers are still faced with artificially high and unpredictable plan liabilities that swell pension costs.

To top it all off, an employer with an under-funded plan may face an inquiry via the PBGC’s early warning program. Armed with significant powers and tremendous resources to stage a protracted legal fight, the PBGC is the proverbial 800-pound gorilla. While it is appropriate for the PBGC to police employers and uncover genuine abuses, its role is not to turn a profit. Yet, despite a weak economy, poor investment returns and low interest rates, the PBGC continues to run at a surplus.

The reality is that pension under-funding is not necessarily the fault of a profligate or venal employer. As most employers have learned to their dismay, a slumping stock market and low interest rates can quickly turn a healthy pension surplus into a deficit. Yet despite the ease with which a pension plan can slip into being under-funded, the Internal Revenue Code not only makes contributions to a fully funded plan nondeductible, it also penalizes such contributions 10 percent. It seems as if Congress just does not want employers to prepare for a rainy day.

The stricture on contributing too much stems from the short-sighted view that qualified retirement plans represent the mother of all revenue losers. Yet by
From the Editor

definition, retirement plans are tax deferred vehicles, in which current tax
deductions for plan contributions and the income earned on those contributions
eventually are recycled into tax revenues as employees retire. Naturally, there is a
cost to the Treasury, depending on the time value of money and future tax rates.
But the analysis should also factor in that a large quantity of the Government’s
deferred revenue from taxing retirement plan distributions will arrive as Boomers
reach age 65 and begin to place a serious strain on the Treasury, including the so-
called “Social Security Trust Fund.”

Moreover, with a misguided sense of fairness that ignores human nature,
Washington has repeatedly scaled back the value of all qualified retirement plans
to members of middle and senior management. Congress started whittling away
at benefits in 1982, when TEFRA reduced the maximum annual pension from
$136,425 to $90,000. In 1989, Congress limited the compensation that could be
counted in determining benefits to $150,000. (Congress restored a small, after
inflation, portion of these two take-aways with the passage of EGTRRA.) As a
result, the senior managers who ultimately decide whether to freeze an existing
pension plan or perhaps install a new DB plan, and the middle managers making
those initial recommendations, personally see little, if any, upside from
participating in a DB plan. With less in it for themselves, most managers
conclude that maintaining a pension plan is just not worth the added risk to the
company or their own careers. Stock options anyone?

To make matters worse, retirement plans must run a regulatory gauntlet
intended to correct perceived abuses. A thousand complex rules and procedures,
including the minimum distribution, top heavy, joint and survivor annuity,
suspension of benefit, affiliated service group and 411(d)(6) rules, must be
digested and complied with. Whenever a doctor tries to short change his or her
staff by manipulating the pension scheme or a new potential for unfairness is
discovered, all employers, large and small, get hit with a new rule. DB plans bear
more than their fair share of these regulations and employers understandably tend
to view them as yet another reason to avoid the additional risks of a DB.

Yet it is clear that many workers would be better off if their employers
devoted at least a portion of their retirement budgets to a DB. Given the extreme
and excessive regulatory burdens in place now, it is up to Congress to help tip the
scales back in favor of pension plans.

As a start, I suggest the following changes:
1. Allow employers to benefit from their prudent investment
management or good luck by tapping a portion of excess assets
without penalty.
2. Allow employers to make deductible contributions to overfunded
pension plans.
3. Allow employers to determine plan contributions using a reasonable
interest rate that better reflects the long term nature of the liability
and is predicable from year to year.
4. Reduce PBGC premiums and encourage the PBGC to act more like a
governmental agency designed to encourage and protect pension
benefits, and less like a for-profit insurance company that’s anxious
to collect premiums and too quick to protect its own interests against a financially strapped employer.

5. Increase benefit limits for executives. The 415 annual benefit limit should be increased to at least $250,000 and the compensation ceiling to at least $400,000, if not higher.

6. Stop trying to “fix” the law by preventing perceived abuses or correcting societal flaws.

As long as we have a voluntary retirement system, legislators and regulators alike must recognize human nature in crafting retirement policy. Pensions have proven a valuable tool over the better part of the past half-century in employers’ efforts to provide workers with a secure retirement. To protect DBs from extinction, their costs need to be made more predicable, plan administration more user-friendly and enough upside must exist to convince executives and their companies to assume the inherent risks and hassles.

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