

# FUTURE OF RETIREMENT BENEFITS

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Defined benefit plans were the main type of retirement plans offered by companies up until the mid 1980s. From the mid 1980s to the present there has been a dramatic increase in the number of defined contribution plans. Companies discovered that defined contribution plans were more beneficial to the company, which resulted in a large number of companies switching the type of retirement plan they offer. This project will explore the reasons why many companies have switched to defined contribution plans and the methods that they have used to switch plans. The switch in plans places more pressure on the employees to invest their money appropriately in order to have sufficient funds for their retirement. This project discusses the pros and cons of these two kinds of retirement plans. This research conducted by M. Muniz.

## **I. Introduction**

The futures of retirement plans are uncertain. Defined benefit plans were the main type of retirement plans being offered by companies until the mid-1980s. From the mid-1980s to the present there has been a major shift from defined benefit plans to defined contribution plans. The main reason for the switch is that defined contribution plans are more profitable for companies. Companies are not investing as much money in defined contribution plans as they do in defined benefit plans. Another possible reason for the change may be a result of the new rule that the Financial Accounting Standards Board (FASB) issued last year. This rule requires modifications to how defined benefit plans are recorded.

Defined benefit and defined contribution plans each have advantages and disadvantages. However, with the increasing number of defined contribution plans it is evident that employers are seeing more advantages to these plans than defined benefit plans. In contrast, the main disadvantage of the increasing number of defined contribution plans is the greater amount of responsibility being placed on employees to invest their money wisely for retirement.

## **II. Defined Benefit Plans**

Defined benefit plans used to be the traditional retirement plan that companies offered their employees. According to the Department of Labor (2007), under a defined benefit plan an employee receives a specified monthly payment when they retire. This payment usually is,

created through a formula that considers salary and service, among other items. A company under this plan accumulates some assets in equity or debt securities (Grant, Grant & Ortega, 2007). The company ensures that it will have sufficient funds to satisfy the pension obligations by investing money into financial assets (Glover, 2007).

Many corporations offer defined benefit plans. Some of these plans have been successful. An example of a successful defined benefit plan is the New York State Teachers retirement plans (“Top Funds by Type,” 2007). However, there are many examples of failed defined benefit plans. According to Davolt (2006), in 2002 United Airlines filed for bankruptcy, which meant that they could not afford to pay their retirement obligations to their employees. As a result, the Pension Benefit Guaranty Corporation assumed United Airlines’ pension obligations (Davolt, 2006).

### **II.a. Advantages and disadvantages of defined benefit plans**

There are many advantages to defined benefit plans that companies find attractive. One of the advantages that will save a company money is the combination of the longevity risk and the insurance principle. The longevity risk is the possibility that one will outlive one’s money. Defined benefit plans are only financed to the employee’s life expectancy instead of to the extreme outer limit of the individual’s life span (Waring & Siegel, 2007). The insurance principle is used when an individual dies prematurely and the excess money is used to pay for those individuals that live beyond the life expectancy (Waring & Siegel, 2007). The company saves money by using this excess money to pay for the retirement of an employee that lives longer than expected.

The lack of excess deferment is another advantage of defined benefit plans compared to defined contribution plans (Waring & Siegel, 2007) Under defined contribution plans if every employee’s was fully funded there would be a great deal of excess deferred compensation. This means that if every defined contribution plans were financed to individual’s maximum possible age the result would be a great deal of unspent money from those individuals that died before they could spend the money.

Another advantage of defined benefit plans is the forced savings for employees (Waring & Siegel, 2007). Forced savings is a hidden advantage for an employee because the savings rate is unknown to the employee. The employee pays in a certain amount of money, according to this rate, that will result in sufficient amount of money set aside for their retirement (Waring & Siegel, 2007).

Professional management is another advantage of defined benefit plans. Having investments made by professional investment managers improves an employee’s chances of having the money well invested than if they did it themselves (Waring & Siegel, 2007). Since defined benefit plans use professional investor managers, they have access to investments that are not available to the average investor. Some examples of these types of investments are real estate, private equity, and hedge funds (Olleman, 2007).

Another advantage for employees is predictable payouts. The amount of money being paid out is the easily calculated, which means that planning for the future is easier for retired individuals (Wilburn, 2007). According to Waring and Siegel (2007), the fees that

employees pay through defined benefit plans are lower than defined contribution fees. The average fees for United States equity funds, which are used mostly in defined benefit plans, are under .5% a year. Retail mutual funds, which are used most in defined contribution plans, are above 1% per year (Waring & Siegel, 2007). Lastly, defined benefit plans can have extra benefits that are advantageous for employees. These extra benefits can include cost of living adjustments, retiree health coverage, and early retirement (Wilburn, 2007).

Defined benefit plans are not without their disadvantages. For employees, one of the flaws with this retirement plan is that it is not portable. The amount of money that was accrued is not able to be taken with the employee if they change jobs before they retire. In addition, employees cannot borrow money against this plan. Also, defined benefit plans cannot be bequeathed to another after that person has died.

Currently, many companies are focusing on the perceived disadvantages of defined benefit plans instead of on the advantages. Companies making the switch view defined benefit plans as dangerous to their balance sheets and income statements. Companies fear that their balance sheets and income statements are being exposed to uncontrollable volatility. In addition, companies view defined benefit plans as being more costly than the alternative, defined contribution plans (Waring & Siegel, 2007). This idea is a result of the financial burden that defined benefit plans place on the company to fund the plan to a set target amount (Glover, 2007).

### **III. Defined Contribution Plans**

Defined contribution plans are very different from defined benefit plans. Under defined contribution plans employers and employees make contributions into the pension accumulation accounts. Employees, typically, are allowed to distribute money into a dozen or so “asset-class” options. Unlike defined benefit plans, where an individual receives payments for their entire lifetime, employees under defined contribution plans usually draw a lump sum amount when they retire from the company (Ambachtsheer, 2007). Some examples of common defined contribution plans are 401(k), 403(b), and 457 plans (Aon Consulting Inc., 2007). A 401(k) plan is a private-sector salary deferral retirement plan that is authorized in the Internal Revenue Code Section 401. 403(b) is a public-sector salary deferral retirement plan that was created in the Internal Revenue Code Section 403. 457 plans are nonprofit-sector salary deferral retirement plan that was created in the Internal Revenue Code Section 457 (History of 401(k) Plans: An Update, 2005).

#### **III.a. Advantages and disadvantages of defined contribution plans**

The advantages for defined contribution plans are employer and employee specific. Waring and Siegel (2007) believe employers’ value defined contribution plans because these plans have a lower out of pocket deferral than defined benefit plans. This results from the lump sum payment that employees receive as opposed to the deferred payments made by defined benefit plans. In addition, under these plans the amount of money that the employer matches is significantly less than in defined benefit plans (Waring & Siegel, 2007).

Employees' value defined contribution plans because these plans are flexible, which means that employees that cannot afford to put money into their retirement plans are not required to (Waring & Siegel, 2007). Defined contribution plans are valuable to employees because employees are allowed to borrow money against their plans (Waring & Siegel, 2007). Each defined contribution plan varies with its borrowing features.

An example of borrowing against a defined contribution plan is evident in the city of Orlando. An employee for the city of Orlando can borrow a minimum of \$1500 (City of Orlando, 2004). The maximum amount of money that can be borrowed is 40% of the accumulated retirement balance or \$50,000, whichever is smaller. Repaying the loan is done through payroll deduction. The amount of the deduction cannot be any more than 20% of the employee's salary (City of Orlando, 2004). In addition, a defined contribution plan is portable and the only item that can reduce the value is poor investment returns (Waring & Siegel, 2007). The portability of the plan means that the amount of money accrued in the retirement plan before that individual retires can be taken to another job if that employee leaves their current position.

Defined Contribution plans are not without its flaws or disadvantages. One major flaw is having the employee invest their own money. Many individuals are inconsistent, hesitant, and irrational when it comes to their own financial future (Ambachtsheer, 2007). There are negative effects of employees being hesitant or not having initiative when it comes to investing money on their own in defined contribution plans.

According to Olleman (2007), these effects can be seen in a study done in Nebraska. In Nebraska, state and county employees hired from 1964 to 2003 were using a defined contribution plan. During this same time school employees, state judges, and state patrols were using a separate defined benefit plan. Over the years leading up to 2002, the return from defined benefit plans were 11% while defined contribution plans only returned 6-7%. Deeper investigation uncovered that half of the defined contribution plan members were only using the default stable fund for their money when they should have had funds allocated in more risky but more profitable stock funds in order to increase the amount of the return that the individuals were receiving (Olleman, 2007).

Individuals are at a disadvantage in investing money for their own retirement. Many people do not know the basic "asset-class" building ideas. For example, an individual in their late 20s should invest more in riskier assets, like stocks, than in safer assets, like bonds because a young worker can wait out the ups and downs of the market (US Securities and Exchange Commission, 2007). An individual in their 40s should have more of their retirement invested in safer assets, like bonds, instead of in riskier assets, like stocks. In this case, this individual is closer to retirement and cannot risk their retirement in the ups and downs of the market (US Securities and Exchange Commission, 2007). In addition, most individuals are not able to identify the risks of these assets (Waring, 2007). Due to this lack of understanding today, many employees invest a great deal of their retirement money in the plan sponsor's stock (Ambachtsheer, 2007). This is a huge problem because if the sponsor's stock price drops dramatically the employee will lose a great deal of their retirement money.

As an example, consider an employee in Ford Motor Company that invested all of their retirement in the company's stock. According to the Wall Street Journal (2007), Ford's stock price in 2002 was approximately \$16 a share. Five years later, on June 23 2007, Ford's stock price was about \$9 a share (Wall Street Journal, 2007). This employee would have lost about half of their retirement money. If this same employee had invested all their money in a mutual fund like Morgan Stanley American Opportunities B the employee would have enjoyed a net increase in wealth. According to the Wall Street Journal (2007), in 2002 Morgan Stanley stock cost approximately \$22 per share. Five years later, the stock was about \$28 per share, resulting in a five year return of 27%. To obtain an optimal portfolio an employee should have diversified investments. The lack of diversification is not a problem under defined benefit plans. Investment professionals know that the best way to invest money is to have a diversified plan (Ellis, 2007).

Ambachtsheer (2007) states that other flaws workers under defined contribution plans face are information asymmetry and misaligned interest with regard to the financial service industry. Information asymmetry occurs when the employer knows more about the trustee of the pension plan than the employee. Misaligned interests occur if the employer receives a kickback for using that trustee's company. In addition, excessive fees hinder employees' abilities in reaching their pension goals. This tends to drive a wedge between workers and the retirement money that they invest. Also, defined contribution plans leave members to bear the burden of the longevity risk (Ambachtsheer, 2007); although it is possible for employees to hedge this risk by investing in annuities when they retire (Waring & Siegel, 2007). Annuities are stable investments that will provide return without the risk of losing money. Investing in annuities is important because it will give an individual the opportunity in having enough money to live on when they retire.

Another problem that employees face under defined contribution plans is having enough money to live on when they retire. One can see from the Nebraska example that if employees do not invest their money appropriately then their return will be almost half of the return from a defined benefit plan. This reduction in money can make retirement difficult. One may suggest that the solution to this problem would be to save additional money, outside the defined contribution plan, in interest bearing accounts. This is very hard for employees to do because payments in defined contribution plans are made from pre-taxed earnings (Chen & Estes, 2007). Saving money outside the plan requires more pre-taxed dollars.

#### **IV. Financial Accounting Standards (FAS) 158**

The Financial Accounting Standards Board (FASB) is making major changes in the first phase of Financial Accounting Standards (FAS) 158. According to FASB (2006), Phase I of the rule requires employers to recognize either overfunded or underfunded status of defined benefit retirement plans as either assets or liabilities. An overfunded plan would be an asset while an underfunded plan would be a liability to a company. In addition, Phase I requires employers to recognize changes in funding status, either over- or under-, in the time period that these changes occurred (FASB, 2006).

One of the main changes in this phase involves a company's disclosure notes. Phase I requires that a company should add any additional information on the effects from delayed recognition of gains or losses on net periodic benefit costs for the next fiscal year in its disclosure notes (FASB 2006). Net periodic benefit costs are the smoothing impacts of gains, losses, changes in prior service benefits, and transition costs (Burrows, 2006). In the industry, smoothing is a company that spreads out its gains or losses over several years instead of recording them all in the period in which they were incurred (Bell, 2006). Phase I of this project, for publicly funded companies, took effect on December 15, 2006. For all other companies FAS 158 takes affect June 15, 2007 (Bell, 2007).

FASB had several goals for creating FAS 158. FASB wanted to make it easier on the users of the financial statements. Before FAS 158, having underfunded or overfunded status appear only in the disclosure notes made it more difficult for the users of the financial statements to assess the company's financial position. In addition, it was difficult to determine the company's ability to satisfy their Projected Benefit Obligation (PBO) (FASB, 2006). In addition, FAS 158 was created to improve financial reporting made by companies. FASB believes that FAS 158 makes information more reliable since it is more complete and timely. Also, it eliminates the alternative measurement date that companies in the past could have used for plan assets or benefit obligations (FASB, 2006).

There were numerous reasons that FASB felt this rule was needed. One major reason was to correct allowances made by previous rules. According to FASB (2006), previous rules allowed employers to recognize a liability that was significantly less than the amount that the retirement plan was underfunded. As a result, companies that did this had an overstated equity section of their balance sheet to make up for the understated liabilities section. Having more equity than liabilities makes the company appear more valuable. Previous rules, also, allowed employers to recognize assets in its financial statements even though the company had an underfunded pension plan. Other rules, also, allowed employers to delay recognition of certain changes in plan assets or obligations that would have affected the cost of providing pension benefits to employees (FASB, 2006).

## **V. How FAS 158 Works and Objections to the Rule**

The major change under FAS 158 deals with the excess of Projected Benefit Obligation (PBO). According to Burrows (2006), PBO is the value of the benefits that have been accrued through the current period. These values are adjusted to reflect any expected future income increases (Burrows, 2006). If a company has a PBO that exceeds the fair market value of the assets than the excess amount will be recognized as a liability. On the other hand if a company has fair market value of its assets exceeding the PBO then that excess needs to be recorded as an asset (Burrows, 2006).

Since FAS 158 is requiring companies to recognize gains or losses in the period that they occurred there are some changes that will affect the smoothing technique. Any gains, losses, changes in prior service benefits, and transition costs should be immediately recorded in the Other Comprehensive Income account (Burrows, 2006). The Other Comprehensive Income account records any amounts that are not part of the processing or

selling of a product. The amounts in this account will be later recognized by the company (Burrows, 2006). As these items, eventually, become a part of Net Periodic Benefits there will be a balancing entry to Accumulated Other Comprehensive Income. Accumulated Other Comprehensive Income is an account of the accumulated year by year adjustments that have been made to Other Comprehensive Income (Burrows, 2006).

There are many companies that are raising objections to FAS 158. Companies are arguing that pension deficits or surpluses should be based upon already built up retirement benefits not on expected income increases. The reason that companies are against using expected income increases is that these increases are not certain and may not happen (Reilly, 2006).

Some companies have problems with how to recognize expected future payments. According to Reilly (2006), these companies argue that obligations that use expected future payments are not liabilities and should not be presented as such on the financial statements. One of the biggest objections from companies is that PBO tends to result in larger obligations than already earned obligations (Reilly, 2006). This means that already earned obligations produce lower deficits or more surpluses for companies. Based on a study by actuarial consultants Milliman, 100 of the country's largest public companies have a combined pension deficit of \$90 billion dollars in 2005. If the already earned benefit method is used this deficit shrinks to about a \$10 billion deficit (Reilly, 2006).

### **V.a Effects of FAS 158 on companies**

The exact effects that FAS 158 will have on companies are not certain at this point. It is possible that FAS 158 will have a negative impact on a company's stock prices. According to Friedman (2006), FAS 158 may show companies as weaker than they were previous to this rule, which means that fewer individuals will choose to invest in the company. FAS 158 may give bond holders more rights at the expense of equity owners. This situation occurs if the company's debt covenants were based upon stockholders' equity and not on the analysts adjusted shareholders' equity amount (Friedman, 2006).

Another possibility is that FAS 158 will have no impact on company's stock price. Under current models, financial analysts have already taken into consideration accounting reform changes. Since the information was publicly available before FAS 158 professionals could just look in a company's disclosure notes to determine the funding status of the pension plans (Friedman, 2006). Since the company's funding status was public before FAS 158 this means that accounting reform changes are already reflected in the current prices of the company's stock. In addition, companies that are experiencing big pension deficits or other problems already have low stock prices (Friedman, 2006).

FAS 158 may increase a company's stock price. FAS 158 could produce less volatility in operating earnings since analysts and investors are focusing on operating costs without adjusting the financials. Under FAS 87 companies were excessively netting components in operating income. Some examples of these components would be service cost, interest cost, expected return on assets and amortizations (Friedman, 2006). With Phase II of FAS 158 the only components that will remain in operating costs will be service costs and possibly

price or service amortizations. FAS 158 could increase a company's stock prices by promoting better analysis and decision making from corporate leader and users of financial statements (Friedman, 2006). The improved analysis and decision making will result in more accounting transparency. FAS 158 will allow a company's Chief Financial Officer (CFO) to manage the company's pension plans better. This would occur since a company's financials are better aligned with the underlying economics of the plans (Friedman, 2006).

However, Reilly (2006) believes that FAS 158 could have a negative effect on a company's net worth. Under FAS 158 many companies will now recognize a larger liability. This increased liability recognition could jeopardize the lending agreements that companies have made (Reilly, 2006). The result of losses of lending agreements is that companies could suffer a lower net worth.

## **VI. Switching from Defined Benefit Plans to Defined Contribution Plans**

In 2003, more than 20% of companies that offered defined benefit plans had taken action to freeze these benefits or were actively considering freezing these benefits in order to switch to defined contribution plans (Chen & Estes, 2007). Companies that are considering this switch have some options to make the switch successful. According to Waring and Siegel (2007), a company could choose to soft freeze the current retirement plan. A soft freeze requires that after a certain date a company stops admitting new participants into the current defined benefit plan. It, also, requires that the company cut down the future accruals of current defined benefit plan participants (Waring & Siegel, 2007).

However, a company could take a more radical approach. A company could decide to hard freeze their defined benefit plan participants. A hard freeze occurs when on a certain date a company terminates the existing defined benefit plan and there are no further accruals for the existing plan participants (Waring & Siegel, 2007).

There are various reasons that companies cite to explain the shift from defined benefit plans to defined contribution plans. According to Ellis (2007), by switching to a defined contribution plan a company can avoid the long term liabilities of defined benefit plans. This means that a company's liability to its employees is reduced. In addition, the attendant risk of quarterly Earnings per Share (EPS) disruptions that result from unexpected changes in interest rates help push companies toward defined contribution plans (Ellis, 2007).

The main reason that companies give for switching to defined contribution plans deals with competitiveness. Defined contribution plans can help a company stay competitive domestically and internationally. Chen & Estes (2007) believe that these plans cut a company's costs and put the company more in line with their domestic competitors that do not offer defined benefit plans. In addition, by switching to defined contribution plans these companies are staying competitive with foreign firms. Many foreign companies have their pension plans covered either by the government or by the personal savings of their employees (Chen & Estes, 2007). Companies that are concerned with the volatility of defined benefit plans are choosing to switch to defined contribution plans to eliminate this issue (Geisel, 2007).

There has been a large shift in the types of retirement plans that companies offer from 1980 to the present. According to Glover (2007), the number of employees that were enrolled in defined benefit plans has dropped 27% from 1988 to 2005. During this time, defined contribution plans increased 39%. Single employer plans have, also, seen a decrease. Since 1980, the number of single employer defined benefit plans has dropped 74.4% to 28,769 in 2005 (Glover, 2007). With the decrease in defined benefit plans it is not surprising that defined contribution plans have almost twice the amount of assets as defined benefit plans. Defined contribution plans hold \$2.68 trillion of assets while defined benefit plans only hold \$1.58 trillion of assets (Glover, 2007).

Public industry is not the only one to see a drop in defined benefit plans. Public industry consists of companies listed on a stock exchange, required to file statements with the Securities Exchange Commission, and closely held, which means that most of the public shares are owned or controlled by a few individuals (Privately Held Company, 2007). Private industry has seen a drop in defined benefit plans, as well. From 1992 to 2005 defined benefit plans have decreased from 25% to 10%. Defined contribution plans have increased from 1992 to 2005 from 44% to 63% (EBRI, 2007).

Recently, there are numerous large companies that are choosing to switch from defined benefit plans to defined contribution plans. General Motors is one of these highly public companies making the switch. According to Larkin (2006), as of January 1, 2007 General Motors is choosing to freeze its current defined benefit plan and is beginning to shift into a define contribution plan. General Motors identified the main reason for this switch was to reduce the financial risks associated with the retirement plans (Larkin, 2006).

## **VII. Conclusion**

It is rather important for employees, in today's market, to take an active role in understanding their retirement plan. Employees under a defined benefit plan need to recognize the large switch that does not appear to be slowing down. Instead of having a secure and predictable retirement future, with a defined benefit plan, many employees are now facing an uncertain retirement. It is up to these employees to properly invest their money in order to have sufficient income for their retirement. Without obtaining proper information or taking an active role in their retirement investing employees, under defined contribution plans, will find it very hard to live during their retirement without getting a part-time job.

The companies conducting the switch from defined benefit plans to defined contribution plans are doing so because defined contribution plans are more advantageous to their company's success. Even though many companies believe that defined contribution plans are more advantageous there are equal advantages and disadvantages to each plan. Although, many companies are make this switch the Financial Accounting Standards Board will continue to monitor and reform pension recognition made by companies.

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