

Perspective



To freeze or not to freeze: Observations on the US pension landscape

In late 2005 and early 2006, a number of high-profile US companies, including IBM, Verizon and General Motors, made significant changes to their retirement programs, transitioning from defined benefit (DB) to all defined contribution (DC) retirement programs.

But this development extends far beyond these corporate giants, with many employers considering moving from DB to DC programs. Of the 316 employers participating in a recent Mercer web cast on the management of frozen DB plans, nearly half were currently considering, or would consider in the near future, a change from a DB to a DC plan. This is in addition to the 24 percent of the employers that had already frozen their DB plans for current employees or closed those plans to new entrants.

This article takes a look at some of the factors driving this change, identifies the issues that employers should consider before heading down the DC path and suggests a framework for assessing these issues. Although we focus on the US environment, these issues are relevant worldwide.

What is a Pension Freeze?

There are two types of pension freezes – hard and soft – that traditional defined benefit (DB) plans can adopt.

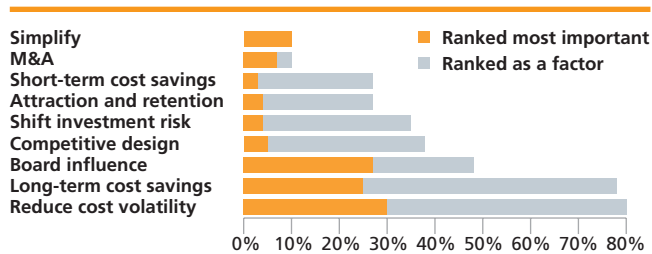
A “*hard freeze*” is one in which the accrual of future benefits is stopped, with no additional benefits accruing for any current plan participants regardless of their length of employment or salary increases.

A “*soft freeze*,” in contrast, is one that lets employees already covered by the plan continue to accrue benefits but restricts future employees or existing employees not yet eligible from participating in the plan. This is sometimes called a “*partial freeze*.”



What is driving the change?

Mercer has worked with many clients over the past few years that were considering a change in their retirement programs. The chart below lists the various factors that companies identified as important in their decision process.



Nearly all companies ranked cost savings or cost volatility (in terms of funding and accounting costs) as key factors, with the volatility issue most frequently ranked as the most important issue in their decision to change. Beyond cost, other factors can be separated into two broad categories: workforce management influences and competitive influences.

For any employer deciding to move from a DB to a DC plan, reviewing the “cost,” “workforce,” and “competition,” from the standpoint of both external trends and internal impact, will help it determine whether the contemplated move will be aligned with broader corporate goals.

Cost influences on pension plans

The drop in both interest rates and stock market values beginning in early 2000 has reduced the funded status of most pension plans, making pension financials significant for many of those organizations that have continued with a DB plan. Although many DB plans’ funded status has improved slightly over the past two years, they are still low relative to pre-2000 levels, and pension expense costs are high relative to the operating income of many companies. In addition, pension funding levels and expense costs are both likely to become more volatile as a result of pending funding law changes in the US and the alignment of US accounting standards with international standards.

Workforce management issues

Another influence on the shift to DC plans is the changing profile of the American worker. DB plans, which work beautifully for career employees, no longer fit emerging employment patterns in many organizations. The long-term career service, a “pay to stay” mentality, is increasingly being replaced by a “pay for performance” philosophy, with the former tenets of security and longevity in the old career pattern de-emphasized as employees become increasingly mobile.

Understanding changing trends is useful, but each employer must dissect and evaluate its own talent needs. Employers should ask themselves what they do to attract, retain and disengage talent and whether these efforts are best supported by a DB or a DC plan. Needs will differ considerably depending on a company’s business model. There are still many businesses, such as hospitals, utilities and technology-based manufacturing industries, where employee mobility would impede productivity because these organizations’ performance is optimized by consistent, predictable employment patterns. On the other hand, for many businesses that are service-oriented and require more generic rather than specific knowledge, increased employee mobility has become a way of doing business and is consistent with good financial performance.

Competitive influences

Another vital step for companies is identifying the competition and evaluating its influence on them. This analysis helps them see whether these influences will drive cost, talent or both in the organization. If a company is at risk of losing market share or underperforming against its peers, cost will be a primary pressure. On the other hand, if the organization must compete for critical talent, this factor could influence the retirement plan design. Matching the competition may be viewed as important for recruiting purposes, but it is a rare organization that competes with one category of competitors for all groups of employees. Moreover, looking at competitors’ retirement programs is tricky because some competitors may be considering or already be implementing new types of plans, so it’s like assessing a moving target.



From a DB to a DC plan: the full implications

Assuming that a review of the cost, workforce and competitive influences has been completed and that moving to an all-DC plan is still attractive, an organization must then thoroughly analyze the financial, benefit and employee-relations implications of such a move.

Financial considerations

As plan sponsors evaluate a possible change from a DB to a DC plan, they may look at cost in several ways: from cash to expense to economic costs, as well as the balance of long-term versus short-term costs. Prior to the change, there are a number of cost components, including the legacy cost related to past liabilities, the ongoing cost of benefits earned in the DB plan annually and the new DC plan cost.

While cost volatility may be a key motive for change, this volatility is driven primarily by legacy plan costs. Unless the sponsor terminates the DB plan completely, these legacy costs will remain even after the change. This means that the reduction in cost volatility achieved by freezing a plan may be relatively minor in the short term, unless there is a major commitment to longer-term, fixed income securities to hedge the interest rate risk. But this strategy typically requires an accelerated contribution strategy and will increase pension expense, due to a lower expected return on assets. For many sponsors of frozen plans, the ultimate control strategy will be plan termination, with a group annuity buy-out from an insurance company. But this typically carries a heavy premium above the ongoing plan liability, due to the conservative purchase rates used by insurance companies.

We've touched here on a few of the financial issues, but there are many more. Our view is that getting a complete financial picture early in the process in order to evaluate the projected financial gains is a good idea. Some DC redesigns have been halted late in the transition process when sponsors have realized belatedly that the new plan would not reduce volatility as much as anticipated.

Impact on employee benefits

Typically, benefit delivery is very different in DB plans compared to DC plans. While sponsors usually have a good handle on the dollars they are spending on these two types of retirement plans, they often don't know how this money is allocated across the employee population; what the potential benefit value is for employees; or what the plan is really accomplishing, either for the employer or employees.

For older, longer-service employees, the change from a DB to a DC accrual will often result in a significant reduction in benefits. Depending on the transition approach, there may be bright lines or specific conditions for eligibility, so that two employees who are situated in nearly similar situations get vastly different benefits. For example, it is common in transitions to protect only employees who are at least a minimum age with a minimum period of service (for example, age 50, with 10 years of service). Where resources are restricted, there is often a trade-off between the amount of core benefits in the new program and the transition benefits for protected employees.

Trade-off decisions can be difficult, and senior executives need to be involved up front. Moreover, such transition approaches usually involve a significant cost over several years, which sponsors must anticipate and quantify as part of the decision process. Lastly, benefits non-discrimination tests (perhaps more specific to the US) must be passed at time of transition and year-by-year going forward. If the group receiving transition benefits includes a majority of high-paid employees (which is not unusual), this can be a major problem, either at transition or down the road.

DC optimization

Historically, DC plans often supplemented DB plans and functioned as basic savings vehicles. Over time, they have become less a reflection of plan sponsors' intentions and more a reaction to vendor capabilities and perceived competitive pressures. Features have been added in a haphazard fashion in an extreme example of "keeping up with the Joneses." The result is a conglomeration of features, many of which contradict each other and the organization's objectives.

For employers that choose to move to a DC plan as their primary retirement vehicle, there will be some work involved in getting the DC plan to perform at a level that ensures it meets the true goals of a retirement program.

***Global Retirement Perspective* is published by:**

Mercer Human Resource Consulting
1166 Avenue of the Americas
New York, New York 10036

Author

Bob Aglira

Editorial Board

Giles Archibald
giles.archibald@mercer.com

Jonathan Barry
jonathan.barry@mercer.com

John Betts
john.betts@mercer.com

Barbara Marder
barbara.marder@mercer.com

Phil Shirley
phil.shirley@mercer.com

Duncan Smithson
duncan.smithson@mercer.com

Denis Stainier
denis.stainier@mercer.com

You are welcome to reprint short quotations or extracts from this material with credit given to Mercer Human Resource Consulting.

Visit us at mercerHR.com

Achieving a high-performing DC plan requires synchronizing the impact of each of four areas that govern it: company contributions, benefit delivery features and adequacy, investments, and participant utilization. A robust DC plan will present a consistent message to employees that reinforces the broader objectives of the organization. For those plan sponsors who have frozen their DB plan, optimization of the new or enhanced DC plan is critical, but it is not enough. These sponsors must think about the interaction between their new DC plan and their legacy DB plan and the effect those two plans will have on participants' retirement income.

In summary

Will the "DB to DC" headlines continue in the US? Probably, for the short term, but the change is not as easy as one might be led to believe. Companies must take a thoughtful, thorough look at cost factors, workforce considerations and competitive influences before wading into the DC pond. A company's workforce is a complex, dynamic enterprise and should be viewed organically before any major changes are made.

The Mercer *Global Retirement Perspective* series contains articles written by senior Mercer consultants that reflect their unique insights and observations on a variety of topics affecting retirement and benefit programs. The views expressed do not necessarily reflect the views and policies of Mercer Human Resource Consulting.

© 2006 Mercer Human Resource Consulting LLC