Escaping Defined Benefit Plan Risk

Investment losses in defined benefit (DB) plans have significantly increased costs at a time when many employers are struggling financially. In light of the business risk related to these plans, many employers are rethinking their retirement plan strategy.

Here is an outline of some of the issues that employers should consider when contemplating changes to their retirement program.

ECONOMIC ADVANTAGES OF DB PLANS

DB plans are an economically efficient way to provide benefits to employees over the long term:

- Professional management of DB plan assets should outperform participant directed investments in defined contribution (DC) plans, such as 401(k) plans. The result is a lower cost to provide the same level of benefit to employees.
- Expense reported on a company's financial statement for a DB plan reflects a credit for anticipated equity premium. This credit does not apply for DC plans, resulting in higher costs.
- DB plans can be used to manage the workforce through the offering of retirement incentives upon voluntary termination. This provides a means to manage older employees, while avoiding age discrimination concerns. DC plans cannot be used in this fashion.

THE TREND TO DC PLANS

The key downside of DB plans is the significant financial risk that accompanies the economic advantages noted above. Costs for these plans can vary significantly from one year to the next as market conditions change, with higher costs kicking in during recessionary periods, such as the current economic climate.

DB plan risk can be managed by modifying investment strategy. However, any significant reduction in risk would minimize the economic advantage these plans provide. As such, many employers have or are considering freezing their DB plan and adopting DC plans, which provide for relatively stable costs by shifting investment risk to the employees.

TREATMENT OF CURRENT EMPLOYEES

Once an employer decides to freeze their DB plan, they must decide whether they will only do so for new hires, or whether they will also move existing employees to the new DC plan.

In general, DB plans tend to reward older, longer service employees. A common misconception is that benefits for these employees cannot be replaced in a DC plan. Rules governing DC plan design permit the grading of contributions by age and/or service, and permit additional transition credits for certain employees. This design flexibility can help employers protect employees moved from a DB plan to a DC plan.

FROZEN DB PLAN STRATEGY

Unfortunately, freezing a DB plan does not eliminate the financial risks and administrative costs for the plan, even though employees do not earn any additional economic benefit. Eliminating cost and risk can only be achieved by terminating the plan such that no additional obligation remains with the employer. Therefore, after an employer freezes a DB plan, it is critical that the employer adopt a strategy for terminating the plan. That strategy should consider:

- The employer's budgetary constraints for funding the plan's deficit and
- Whether the plan's investment strategy should be modified to reduce or eliminate equity exposure to align the employer's risk tolerance with the shortened time horizon for the plan

ESCAPING DB PLAN RISK

This article outlines only a few of the complex issues that employers face when considering moving away from DB plans. If you are interested in a comprehensive review to address your particular circumstances, or if you have questions about any design considerations, please contact Chernoff Diamond & Co., LLC:

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Chernoff Diamond & Co., LLC has the resources and expertise to help plan sponsors review the complex considerations for determining retirement program strategy in a manner that will achieve their business objectives.