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## Congress expected to repair problems with pension plans



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**M**any retirement industry experts expect the 111th Congress to undertake an extensive review of our retirement system.

Time has shown that defined benefit pension plans suffer from a fatal flaw: They spread risk without being clear about how, and by whom, the risks are borne. Surpluses in defined benefit plans lead to employers becoming exempt from the requirement to make their annual contributions, as well as result in plan participants and corporations fighting over the ownership of the surplus. Regulators, and even the courts, often step in to arbitrate the disputes.

Similarly, when surpluses turn to deficits during market collapses, plan participants become at odds with bondholders and shareholders about how the financial shortfall should be allocated.

A good example of the surpluses happened in the late 1990s, when excess funding was spent on increased benefits and lower contributions, and by making it less expensive for plan participants to purchase years of service. Having benefited nicely from these surpluses, defined benefit plans have loaded the current financial shortfall on the backs of younger and future employees.

Defined contribution plans eliminate the ambiguity about risk and asset ownership by shifting the bulk of the risk to the employees and placing assets directly in the employees' names. But defined contribution plans are not, as we have learned over the years, without flaws of their own.

There's no need to delve deeply into behavioral finance to confirm that employees who are required to take responsibility for their defined contribution investments are often hesitant, indecisive and even irrational when it comes to planning their financial futures. Many employees have no desire to obtain the knowledge necessary to manage their retirement accounts.

Defined contribution plans also require that plan members bear the burden of longevity risk. With the defined contribution system still relatively young, it's impossible to fully measure the impact of longevity risk. However, the idea of exposing the nation's retirees to the risk of outliving their money isn't an attractive option.

### Where do we go from here?

President Barack Obama so far has called for modest changes to the defined contribution system, such as temporarily allowing penalty-free withdrawals for people facing economic trouble and suspension of the required minimum distributions for retirees over 70½. Waiving the 10 percent penalty and easing the required minimum distribution rules were part of the American Benefits Council's 10-point plan, presented to Congress in October 2007. Its proposal outlined ways to help individuals get through the tough economic times and encourage future retirement saving.

It's unclear what legislation Congress may enact this year or what the future retirement plan landscape may look like. However, the features that will guide the design of changes may include:

- **Universality:** a similar opportunity to save, whether employees work for a corporation, charity or the government.

- **Adequacy:** the ability of the plans to ensure that the amount required for a secure retirement is contributed to the retirement plan.

- **Simplicity:** simpler designs that reduce costs and boost the returns for plan participants.

Characteristics of a defined contribution system that includes these features may include:

- Automatically enrolling all but very short-term workers into a retirement plan that requires some type of mandatory contribution.

- Using a trigger to dynamically adjust individual contribution rates to respond to asset surpluses or deficits over time.

- Increasing contributions as the default option every time employees get a pay raise.

- Making professionally managed life-cycle options the default investment, with the employees' asset allocation changing as they approach retirement. These life-cycle options are similar to today's target retirement date funds.

- Addressing longevity risk by including the purchase of deferred life annuities through time.

- Making transparent the amount of the post-retirement income benefit that the account can purchase by making an inflation-indexed annuity as the default distribution option.

- Having plans serviced by organizations with no conflicts of interest.

Similarly, a new breed of defined benefit pension plans could include:

- Benefits that would be based on current pay, not employees' highest or final pay. This approach would eliminate the need for an employer to currently fund benefits for future salary increases. If an employee quits before retirement, the benefit would have the same value as the accrued retirement benefit.

- The value of future benefits would be communicated regularly to each employee. The value of the benefit would be transparent, which is a feature that employees find attractive in defined contribution plans.

- The benefit would be reasonably portable, as businesses are less long-lived than in the past and workers tend to change employers more often.

- The benefit would be valued as accurately as possible and would be fully funded at all times.

- Funding would include an additional reserve to cover the risk that actuarial estimates of value may be incorrect.

Any changes to our current system however, should focus on the goals of delivering a target retirement income starting on a target retirement date. If working Americans want to achieve a certain level of retirement income and the current system doesn't provide for it, they have only a few choices: Save more, take more investment risk, retire later or reduce expectations for their future lifestyles.

Whatever system we save under won't close the gap for all of us. This problem isn't just an employer or government burden. Americans, who seem to live for today, need to be better savers.