

# Rethinking the Pension Freeze

The case for retaining a restructured defined benefit plan that benefits both sponsors and employees



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The trend to freeze pension plans is old news. The decline in the number of defined benefit (DB) plans has been getting a lot of coverage in the media for quite some time, with more employers moving to defined contribution (DC) plans. In one respect, the numbers bear this out. According to the Pension Benefit Guaranty Corporation (PBGC), there are only 38,000 DB plans today, compared to 114,000 in existence in 1985.<sup>1</sup> However, the decline occurred mainly among plans with 100 or fewer participants. Today, the PBGC continues to insure the pensions of more than 44 million participants.<sup>2</sup> Thus, it's fair to say that rumors of the complete demise of the DB plan are greatly exaggerated.

At the same time, many of the remaining DB plans are frozen, and fallout from the market downturn in 2008 has caused a large number of the remaining employer sponsors to look again at the freeze option. These reviews of pension plans are prudent. While many current retirees are the beneficiaries of prior pension plan participation, employers must pay attention to the bottom line, and the cost volatility generated from most pension plans has simply been too high.

In their reviews, however, we suspect that some employers may move to adopt a DC-only strategy without adequate consideration of viable DB options that could result in better retirement outcomes, comparable costs, and tangible benefits to the sponsor. This article provides a detailed comparison of the prevailing strategy that freezes the DB plan versus an alternative approach that preserves the existing DB plan. By preserving the DB option, sponsors can provide a valuable DB core benefit—combined with a DC supplemental benefit—that results in a cost structure similar to a DC-only structure.

## THE RISE OF THE DC PLAN AS A CORE BENEFIT

For most mid-sized to large employers, the traditional DB pension plan was the preferred retirement vehicle for many years. When the pre-tax saving option became available under section 401(k), plan sponsors took advantage to set up savings plans for their employees. Initially, these were intended by employers as supplements, not replacements, for traditional pensions.

However, as the workforce became more mobile and the securities markets grew, employers and employees alike started viewing the standalone DC plan as a viable alternative. As the great bull markets of the 1980s and 1990s roared ahead, employees gravitated toward DC plans that they could take with them to the next job. DB plans seemed complex and abstract. Who wanted an annuity payment

upon retirement when you could see popular mutual funds growing with double-digit returns year after year?

And, from the employers' perspective, why should they encumber themselves with investment responsibilities when employees didn't appreciate the benefit they were receiving? Plan sponsors began to gravitate toward DC plans as their primary retirement vehicles—even at a time when the bull market was making DB plans "cost free" for many employers.

The first decade of the 21st century has flipped this story. Bounded by the bursting of two bubbles—dot-com and housing—the 10-year period delivered gut-wrenching downside volatility with huge losses for most investors. For those near retirement or just retired, DC plans revealed themselves as flawed vehicles, if not outright failures. Sponsors of DC plans saw their older employees unable to retire and younger workers clamoring for some kind of guarantee.

At the same time, employer contributions required to restore asset levels of underfunded DB plans have exploded. Pension funding rules require a relatively short amortization period, and pension liabilities are now measured at low market discount rates. Now that employees finally appreciate the value of that annuity payment upon retirement, more employers are heading for the exits.

## THE SPONSOR'S CURRENT DILEMMA

Let's look closer at what drives the equation for a sample plan sponsor who has retained both a pension plan and a 401(k). Assume the pension provides the following benefits:

- A generous annuity with annual accruals based on 1.25% of final average pay
- Significant early retirement subsidies, with unreduced early retirement at age 62
- Enhanced benefits for disability

In addition, the employer provides a 401(k) plan, with employer matching contributions up to 3% of pay for employees who contribute 6% of pay or more.

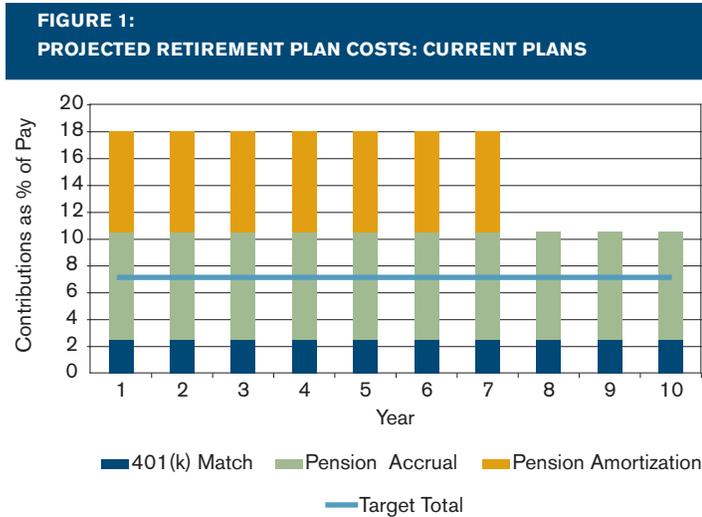
Historically, the target cost for the pension plan was 4% to 5% of employee pay. This target was based on an 8% discount rate, reflecting assumed investment returns. Combined with the DC plan's

matching contributions, with a net cost of 2.5% of pay after reflecting participation and forfeitures, the target cost for all retirement benefits was 7% of pay. However, for most of the 1980s and 1990s, employers were fortunate and enjoyed investment gains well above expectations: This situation prevailed for our sample employer, and actual pension costs were lower than the target, with no pension contributions in many years.

In the current environment, however, total DB/DC retirement costs are more than double the 7%-8% target. Total costs for our sample employer are now 18% of pay, broken out as follows:

- The employer's cost for matching employee contributions to the DC plan remains on target at 2.5% of pay.
- The annual accrual cost in the DB plan now equals 8.0% of pay, representing the cost of the accrual for the following year. This is nearly double the prior target, because pension liabilities must be valued with much lower market interest rates, in the 5% range, compared to the 8% assumption used for the historical target.
- Because of investment losses, the DB plan must also amortize its unfunded obligation. This adds an extra cost projected at 7.5% of pay for the next seven years, after which it should be retired.

These costs are illustrated in Figure 1.

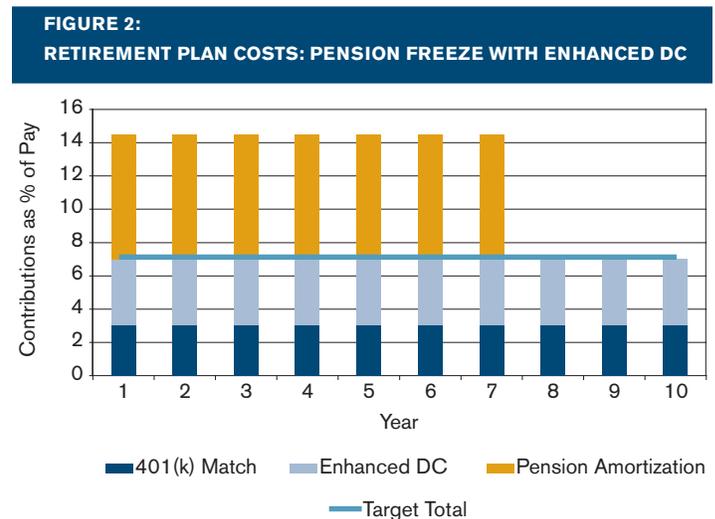


It would not be surprising if our sample employer concluded that retirement costs at this level are unacceptable. A review of competitive benchmarks for employers without DB plans shows total retirement costs should be in the range of 6% to 8%, consistent with the employer's historical target. With this as a goal, the employer's initial analysis might quickly result in the following plan:

1. Freeze the DB plan, to eliminate the cost of accruals of 8.0% of pay.

2. Increase the maximum DC match from 3% to 4%, and add an additional non-matching contribution of 4% for all employees. In total, this produces an expected DC cost equal to 7% of pay after considering participation levels and vesting.
3. Maintain the current asset allocation in the DB plan. Initially, the amortization costs of funding the DB plan deficit will continue at 7.5% of pay for a projected period of seven years. However, if investment returns exceed the current bond yield rates, this cost will come down over the seven-year period. The reverse will be true if investment results are poor.

These costs are illustrated in Figure 2.



This scenario has played out at many organizations. The projections reveal that the costs to fund the pension deficit do not go away immediately with a freeze. However, they are projected to go away at some point, and the total costs for the enhanced DC plan are at the target level. Even more important, these costs are stable and predictable, without the uncertainty of the pension plan.

This strategy would work. *But is there a better alternative? We submit that there is.*

**THE PENSION VALUE FOR EMPLOYEES**

Let's step back and review the value of the pension plan for employees. Without detailing the full comparison between plan types, we emphasize four critical advantages that DB plans provide for employees:

1. The DB benefit provides increasingly more value to employees the longer they remain with the employer. Employees see this value as they work through their career. In the past, the actual dollar value of the defined benefit was harder for employees to understand, but with today's online tools it is much easier to model retirement benefits under different scenarios.

2. A core DB benefit can provide additional value and flexibility to an employee's DC plan. The pension benefit can serve as the conservative foundation of the retirement benefit, allowing the employee to invest in his or her DC account with more flexibility and comfort.
3. In late career, the pension benefit allows employees to plan for retirement with the confidence that they will be able to stop working on the date they've chosen—without worry about market movements.
4. Finally, and most important, is what we call *the 85-year-old test*. How many of us know a relative or friend in retirement living on Social Security alone, with their DC plan benefit long since exhausted? We ask: How much better off would these people be with just a small DB annuity to supplement Social Security? Simply put, the DB benefit is the superior retirement benefit *in retirement*.

With these clear benefits to employees, a look at alternatives makes sense.

#### FUNDING THE PENSION DEFICIT—THE UNAVOIDABLE COST

Pensions certainly provide value to employees, but what about the cost to the employer? The financial question raised by the sample case illustrated above is straightforward: How can an employer justify the greater cost of the DB plan?

To answer this question, we will first split future pension costs into their two components—accrual cost and amortization cost. Let's examine the amortization cost first. As illustrated by the charts in Figures 1 and 2, the amortization cost remains even if the plan is frozen. It is also true that there is potential variability in funding this cost, but *this variability is independent of the decision to freeze the plan*.

The employer can choose to limit the variability through a conservative investment approach—essentially linking investment variability with liability variability through a liability-driven investment (LDI) strategy. This approach limits the additional losses, but also eliminates the probability of any significant investment gains, thereby locking in the high costs over the amortization period.

Alternatively, the employer can retain a more traditional asset allocation with significant equity investments, even after a freeze, with the goal of capturing gains to reduce the amortization cost. Either approach, or something in between, is available to both sponsors who retain ongoing DB plans and to sponsors who freeze their plans.

#### THE RIGHT COST COMPARISON—FUTURE PLAN ACCRUALS

For many sponsors, the amortization cost is a big number and a significant challenge. However, this cost is now unavoidable. As such, amortization costs should have no impact on the sponsor's decision on future plan design. Plan design should be concerned exclusively with the cost for benefits accruing in the future. *In other words, the cost of future benefit accruals, both in magnitude and potential volatility, should be the focus of the plan design decision.*

Under this approach, the sponsor may still quickly move to a freeze decision, because the accrual costs are higher, and the continuing pension accruals may expose the employer to another large pension deficit in the future. However, we should look at both of these factors more closely.

Let's discuss cost volatility first. This volatility is driven primarily by investment gains and losses, particularly from equity investments. The other major source of volatility is discount rate changes. Both can be minimized with an alternative LDI investment strategy. Under this strategy, plan assets move largely in sync with plan liabilities. While this strategy eliminates the opportunity for future gains to significantly reduce contributions, it does not increase current funding costs, because *current* funding rules already measure liabilities using market discount rates similar to an LDI strategy.

Depending on its risk tolerance, the sponsor may choose to invest partially or fully in an LDI strategy, or transition to a full LDI strategy over time. For purposes of the freeze decision analysis, the employer has the option to adopt an LDI strategy for investments tied to future plan accruals, regardless of the strategy for prior accruals. If the sponsor adopts this approach, exposure to future pension volatility will essentially match the volatility under a DB-freeze approach. The volatility for past accruals will be similar for each, and will depend on the investment strategy, while the volatility for future accruals will be minimal for each, whether under a DC benefit or a DB benefit with an LDI investment strategy.

#### WHAT ABOUT THE COST?

The next question is the expected cost of future pension accruals. The lower volatility comes with a cost, because the value of these accruals is determined using low market interest rates. This cost is reflected in the higher accrual costs today, under current funding rules. For our sample employer, this is the source of increase in accrual costs from the historical target of 5% to the current 8% level. This 8% cost level, even though it may be a stable cost, is still too high. It is above our 7% target without considering any DC plan cost.

But is it possible to retain a valuable pension benefit at a lower cost? In particular, can we modify the plan design and still retain a core pension benefit similar in cost and superior in value to an enhanced DC benefit? The answer is yes.

The cost of a pension benefit is a function of the plan features. A review of plan design and costs should focus on the following:

- **Plan formula:** Consider increasing the number of years of pay in a final-average-pay formula, or moving to a career-average formula. A cash balance plan is another option that can significantly revise the cost. Also, review what pay is included in the formula, and consider excluding variable pay such as overtime or bonus.
- **Plan formula factors:** Is the accrual factor at the right level (e.g., 1.25% of final-average-pay times years of service)?
- **Early retirement:** Subsidized early retirement is not only expensive, but can produce unwanted employee behavior. The

subsidy may incent a valuable employee to leave after the magic retirement age, and keep a disengaged employee from leaving prior to this age.

- **Disability:** Most employers have a separate long-term disability (LTD) benefit. The inclusion of disability benefits in the pension plan brings cost and extra volatility to the plan.

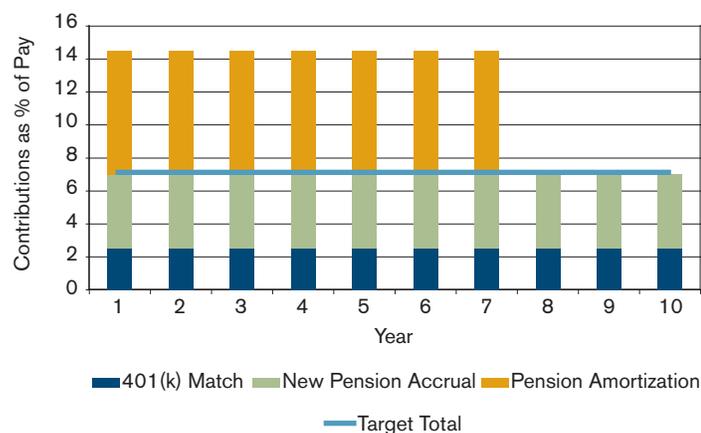
Let's look again at our sample employer. In order to retain the DB plan and keep its target cost structure at 8% of pay or less, the employer moves to an LDI strategy for future plan accruals. In addition, the employer takes a hard look at the plan design and adopts significant changes for future accruals:

- Reduce the accrual rate from 1.25% to 1.00% per year of service
- Change the formula from final-average-pay to a career-average-pay, where the accrual each year is only calculated from pay in that year
- Eliminate early retirement subsidies, so that future accruals will reflect full cost at normal retirement age, with no incentive to retire early and no penalty to retire late
- Eliminate special disability benefits

With these changes, the cost of future accruals is reduced dramatically, from 8.0% of pay to 4.5% of pay. In addition to cost reduction, these changes bring the added benefits of simplicity and stability in benefits. Simplicity reduces plan administration requirements and helps employees understand the plan. Stability in benefits reduces cost volatility in plan operation by limiting actuarial gains or losses that are due to retirement dates, pay volatility, and disability frequency.

Our employer's future costs are now illustrated in Figure 3.

**FIGURE 3:  
RETIREMENT PLAN COSTS WITH RESTRUCTURED PENSION PLAN**



These projected costs are similar to the costs illustrated above under the plan freeze option. *It's important to note that they are similar not only in the expected level, but also in terms of expected volatility.* In particular, under each scenario, volatility may remain with the funding of the amortization cost, depending on the investment strategy, but there will be limited volatility in the future accrual cost. In fact, the level will be similar to the low volatility of DC plan costs.

Certainly, the pension plan benefits have been reduced significantly, and communicating the changes will be difficult. However, this communication is better than communicating a plan freeze. Employees will also understand the ongoing commitment by the employer to provide them a retirement foundation. In particular, the core DB benefit provided from the new formula, while not what it had been, will still provide the critical DB plan advantages outlined above.

**THE BUSINESS CASE**

Our example illustrates that the employer's costs in maintaining a modified DB plan can be similar in both amount and volatility to what they would be under a DB-freeze approach with an enhanced DC plan. This modified DB plan is less valuable than the prior plan, but from an employee's perspective it is superior to what the DC enhancement benefit provides.

For the employer, the additional business case for the DB plan lies in the DB benefits outlined for employees. A closer look at the employee benefits shows these corresponding benefits for the employer:

- DB plans attract quality employees from outside the organization. The decline in DB plans comes at a time when employees have a greater appreciation for these plans.
- DB plans retain longer-service employees—particularly the mid-career employees who are often the most valuable employees in an organization. Employees in the organization appreciate the increasing value in a DB plan as they remain with their employer. Morale is improved. Compared to a DC plan, the employer has an efficient and less costly mechanism to provide greater value to longer-service employees.
- The DB plan's ability to help employees plan for a retirement date has value for an employer in managing its workforce. In a retirement environment dominated by DC plans, experience in 2009-2010 has shown the dependence of retirement rates on investment results. For many employers, this experience has worked against their needs. In an economic climate where more retirements may have been welcome, fewer employees have been able to retire. The reverse may be true following a period of investment gains—retirements may spike when business is booming and employers want to retain employees. A core DB plan helps mitigate these retirement swings. Employer workforce management is less dependent on investment performance and 401(k) account balances.

In summary, DB plans are an effective tool to manage a workforce. When properly designed, they can help attract new employees, retain valuable employees, and retire those who are ready to leave.

### CONSIDERATION FOR A THAW

Our focus above is on employers with an ongoing plan who are looking for changes. However, many employers have made the change to DC-only, either through a hard freeze or soft freeze with new employees limited to the DC benefit. For some, the DC-only structure may be working. Others, however, may be increasingly worried about the inability of their retirement programs to meet employees' retirement needs and the employer's need to transition employees to retirement.

Such an employer with a frozen plan can similarly benefit from a core DB structure. Reopening the DB plan with a core benefit funded with an LDI structure can replace a DC contribution enhancement. As outlined above, the core DB benefit can be structured to mirror the DC enhancement in terms of cost, with limited volatility, and provide superior benefit value to both the employee and the employer.

### RETHINKING THE EQUATION

Despite the media drumbeat, DB plans are not dead. They continue to work for many organizations. However, there is a steady decline in DB sponsorship, and high contributions in the years ahead will cause more organizations to think again about the freeze option.

Our initial illustration shows how a freeze decision seems logical if the pension plan is not affordable. However, the additional examples illustrate how in-depth analysis may result in an alternative DB plan with reduced cost and volatility. This further analysis should be part of every plan design decision process.

Current trends in DC plans focus attention on the retirement benefit provided. Options examined include automatic enrollment, target date funds, and life payment options. At some level, this focus is in response to the failure of DC plans to function as adequate retirement plans.

While these changes to DC plans are helpful, DB plans are the ideal vehicles to provide core retirement benefits. The irony is that DB plans are being eliminated at the same time these DC changes are being reviewed. For employers with a DB plan in place, frozen or not, the value of that plan as an ideal retirement benefit should not be undervalued. The option explored in this article provides a valuable DB core benefit that, combined with a DC supplemental benefit, results in a cost structure similar to an all-DC plan, and provides superior benefit value to both the employee and the employer.

### ENDNOTES

- 1 IRS.gov (Aug. 5, 2010). Choosing a retirement plan: Defined benefit plans. Retrieved August 20, 2010, from <http://www.irs.gov/retirement/article/0,,id=108950,00.html>.
- 2 Pension Benefit Guaranty Corporation (2009). Summary of operations. Pension Benefit Guaranty Corporation Annual Report 2009: p. 6. Retrieved August 20, 2010, from [http://www.pbgc.gov/docs/2009\\_annual\\_report.pdf](http://www.pbgc.gov/docs/2009_annual_report.pdf).

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