

## WHAT PEOPLE EXPECT FROM A PENSION PLAN

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When people get what they expect, they are happy. When people do not get what they expect, they get upset. A lot of Americans are upset today with their retirement plans. The Financial Accounting Standards Board (FASB) and Congress are taking action, but the actions they propose will create more problems than they solve. Underlying everything is a substantial disconnect between rule-makers and the public. The public has a more simplistic view of a retirement plan than rule-makers do. Rule-makers need to keep in mind the simplistic way ordinary people think of a retirement plan.

Ordinary people think of money being set aside each year during employment. They imagine an account accumulating and growing — not shrinking — each year of employment. At retirement they imagine this account being available to pay a pension. This describes a cash balance plan more accurately than it describes a traditional pension plan or a defined contribution plan, like a 401(k) plan. Cash balance plans match what laymen think a retirement plan should be, and they are therefore popular. Cash balance plans are popular because they give ordinary people what they expect of a pension plan.

Let us look at this in more detail. The layman does not think in terms of an *accrued benefit*. The layman thinks in terms of a cash account. The layman does not start thinking about monthly annuities until close to retirement. Furthermore, the layman does not anticipate shrinking present value — either through investment losses or through increasing interest rates.

A defined contribution plan, like a 401(k) plan, has an account value expressed in dollars, which appeals to the layman. When the account loses value, however, the layman feels cheated. In the case of self-directed accounts, the layman may move out of an investment category after the losses have happened and thus may chase the market. The layman may stay in cash for years so as to avoid losses altogether. If the employer directs the assets, the layman may blame the employer for any losses.

401(k) defined contribution plans with self-directed accounts will work properly only if participants are trained to invest. Schools teach students to drive. They need to teach everyone to invest. An appropriate curriculum can be found in the first Chartered Financial Analyst (CFA) exam, or other sources. School is the best place to teach this topic. A page or two of investment education from an employer is not enough. As we switch from defined benefit pension plans to defined contribution 401(k) plans, we are transferring management of the nation's wealth into the hands of untrained investors. In the long run, untrained investors will be upset with the mismanagement of their assets.

Cash balance plans are popular because they are what laymen expect of a pension plan. Laymen expect to see an account that goes up each year. The layman envisions an employer setting aside money each year and building up a fund to pay for retirement and then providing an annuity from the fund. The layman envisions the retirement annuity and the fund both getting larger with each year of service an employee works for an employer. The layman does not expect the relationship between the fund and the annuity to vary with changing interest rates.

As actuaries, the relationship among interest rate, annuity amount and present value is second nature to us, but the layman does not anticipate this relationship — at least not a varying relationship on account of varying interest rates. No layman expects the lump sum cash-out of an accrued pension benefit to go down from one year to the next because of rising interest rates.

In 1981, long-term corporate interest rates rose to 16%. Think about what a spike like this can do to pension plan funding, financial accounting and lump sum cash-outs, when you tie all liabilities to prevailing interest rates. A poorly funded pension plan that is struggling with overwhelming contribution requirements at 5% today can be enjoying a contribution holiday at 9%. What about 16%? 16% is not impossible. It happened once. It can happen again. When rising interest rates turn very under-funded pension plans into vastly over-funded pension plans, the public will see it as accounting legerdemain and as the defrauding of ordinary workers rather than as the proper working of the system.

Suppose you were born in 1981, and your pension benefit is worth \$5,000 in 2007 at 5%. What is it worth at 16%? You might be surprised to learn \$52. If you are 26 years old, an 11% spike in interest rates means you get a penny on the dollar. A spike in interest rates means a windfall for employers and upset employees. Low interest rates, like today, are the reverse. Employers are upset with defined benefit pension plans today because they did not expect large unfunded liabilities on account of low interest rates. Employees will be upset tomorrow when their lump sums decrease because of rising interest rates.

When the Pension Benefit Guarantee Corporation discounts its liabilities using an interest rate less than 5% and complains about how under-funded pension plans are, the public gets the impression that employers have somehow pilfered the funds. The public does not understand that pension plan liabilities can swing by a factor of ten on account of changing interest rates (or in the case of a 26-year-old by a factor of nearly 100). These huge swings are the result of applying theoretical bond pricing models to the valuation of a pension plan. In these models, a pension plan has a longer duration than any available bond, so falling interest rates tend to make pension plans under-funded, and rising interest rates tend to make pension plans over-funded.

Theoreticians have latched onto the accrued benefit as an immutable fixed point, about which the pension plan liabilities must swing madly up and down. The public wants stable pension plan liabilities, but theoreticians who make rules insist on holding the accrued benefit fixed and varying the liabilities.

It does not have to be this way. If Congress were to permit lump sum cash-out rates to be fixed at a single interest rate, e.g., 8%, then funding and accounting rules could apply the same interest rate, and everybody would be happy. A pension plan is not a bond traded on a public market. It is a payment arrangement that ought to be what employers and employees expect it to be. Employees would be happy to have a lump sum cash balance that grows at 8% interest each year. Employers would be happy to fund on this basis.

The only ones insisting on prevailing interest rates are the rule-makers. The rule-makers started with the lump sum cash-out rates. For many pension plan sponsors these mandated interest rates only applied to small lump sum amounts, so it was a negligible topic for them, but the seed was planted. Later, the rule-makers extended prevailing interest rates to current liability calculations and to pension plan accounting. Now they want to *increase* the volatility due to fluctuating interest rates, by eliminating the use of four-year and five-year averaging. The use of fluctuating interest rates for lump sum payments underlies their mandated use in funding and accounting. The public does not demand this blind adherence to the bond market.

The public expects every pension plan to have a single number that represents the liabilities of the pension plan — a number like the total of all the accounts in a cash balance pension plan. Instead of a single number, rule-makers in Congress and the Financial Accounting Standards Board, have given the public a bewildering array of competing liabilities — PVB, UFAAL, EAAL, UCAL, PUCAL, vested current liability, pre-PFEA current liability, post-PFEA current liability, current liability for maximum, gateway current liability, PBGC variable premium liability, EBO, PBO, ABO, VBO, plan termination liability and various categories of 414(l) spin-off liability. Is the

public confused? Of course. Are Congress and the FASB confused? Probably, but Congress and the FASB have nobody to blame but themselves for creating this opaque mess.

In an effort to create clarity out of confusion, employers, with the help of consultants, implemented cash balance plans. The public likes cash balance plans, because they are easily understood. Who hampers and interferes with these efforts? Who demands whipsaw effects? Who perceives age discrimination when equal amounts of money are assigned to employees of different ages? Only some district courts. The notion of defining an accrued benefit as an immediate lump sum amount — a cash balance account — which is what the public expects, unsettles the theoretician judges who insist on viewing these plans through the lens of the “accrued benefit.” Instead of conforming to the public’s expectation of what a pension plan ought to be, some court rulings insist that the frame of reference must be a deferred annuity, with all the consequent confusing array of liabilities and unreasonable volatility year to year.

Rule-makers are out of step with the public. Rule-makers insist on tying pension rules to deferred annuities and fluctuating interest rates. The public does not expect this. Accountants and congressmen who are bedazzled by bond pricing models and bewitched by yield curves should beware. Laymen do not expect the consequences that result from rules tying everything to fluctuating interest rates.

New funding and accounting rules may alleviate some issues for cash balance plans, but they will make matters worse for traditional annuity plans, and they will increase public unrest. The root of the problem, however, is not in the funding and accounting rules. It is in the lump sum rules. The solution is to permit a single interest rate, e.g., 8%, for computing a lump sum cash-out. Funding and accounting can then follow suit and use the same interest rate.