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Commentary

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The Case for Defined Benefit Pension Plans

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Defined Benefit (DB) pension plans have become unfashionable. Concerns about the cost of DB provision have led corporations to terminate existing DB plans, while new plans are overwhelmingly Defined Contribution (DC). This trend in favor of DC provision is already far advanced in the US and Australia, with other countries following rapidly in their wake.

This development has brought decidedly mixed blessings to employees. It is true that DC plans provide transparent and portable benefits, while giving participants some control over the investment of their personal fund. The existence of investment choice, however, does not shield the participant from investment risk. The conventional advice is that participants should invest in equities when young and switch to bonds on nearing retirement. Although this strategy does reduce some of the risk, it cannot change the fact that the benefit provided by a DC plan depends heavily on investment returns over the participant's period of employment.

Consider US equity returns over the last half-century. The data indicate that the accumulated real return over any 20-year period depends greatly on which 20-year period is selected. The fund accumulated to the end of 1999 would have been twice as great as the fund accumulated to the end of 2002, and many times greater than the fund accumulated to the end of 1979. How are plan participants to cope with such volatility? They could invest in inflation-indexed bonds, but the greater certainty in returns would come at the expense of lower average returns and (therefore) higher contributions. They could hedge their portfolios with derivatives, but this is expensive. Portfolio insurance is equivalent to buying when the market is high and selling when the market is low, a strategy that is not likely to produce satisfactory results in the long-term. What plan participants really need is a method of *intergenerational smoothing*, which means that participants who are lucky enough to retire when the market is high sacrifice some of their gains to subsidize participants who retire when the market is low. And this brings us back to DB plans.

The great advantage of the DB plan is that it permits the intergenerational smoothing of investment returns. Participants receive a benefit that is independent of actual investment performance over their period of service, on the understanding that there will be times when the plan is in surplus and times when the plan is in deficit. These surpluses and deficits need not cause difficulties if the plan sponsor is a sound business with a long-term commitment to the plan. Surpluses and deficits can then be amortized over long periods to ensure that the sponsor's contribution is relatively stable. Another advantage of the DB plan is its ability to provide benefits linked to salary. Pension plans are a form of compensation, so it is extremely important to the sponsor that employees place a high subjective value on their benefits. This is more likely to be the case if the plan provides benefits that cannot be purchased in the market and are linked to perceived needs.

DB plans do have their disadvantages. If benefits are linked to final salary, there are potentially undesirable cross-subsidies; participants with rapid salary growth and long service obtain more valuable benefits, per year of service, than other groups. These features, however, can be removed at a stroke by linking benefits to revalued career average salary rather than final salary. The resultant plan would then resemble a cash balance plan, a form of provision that has gained some momentum in the US and will hopefully become more prevalent throughout the world.

Other problems relate to regulation and accounting requirements. Over-prescriptive funding requirements are a strong disincentive for an employer to maintain a DB plan. Regulators should be aware that surpluses and deficits are an inevitable feature of DB pension provision. It makes no sense to force a plan sponsor to meet onerous solvency requirements if this will threaten the survival of the business on which the plan ultimately depends. The need to cover vested benefits must be weighed against the need to ensure that the survival of the plan and its sponsor are not put in peril in difficult economic periods. Conversely, DB plans should be allowed to maintain large surpluses during a bull market as a margin against the possibility of unfavorable experience in the future.

The issue of how DB pension costs should be recognized in the financial statements of the sponsor is a vexed and controversial question. In the UK, a new accounting standard that will require pension costs to be recognized on a mark-to-market basis has been blamed for causing corporations to terminate their DB plans. My personal view is that the UK standard has gone too far in requiring the immediate recognition of gains and losses and that the FAS 87 approach is more appropriate. But whatever one's view, it does not make sense that a financial reporting standard should affect how a business rewards its employees. If DB plans are a valuable method of compensation—as I believe—this economic reality cannot be changed by having to report pension costs in a particular way.