

Commentary

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Save the Whales!

Defined Benefit (DB) pension plans are a dying species that risks extinction unless a vigorous campaign is undertaken with the same sense of dedication and commitment that characterized the "Save the Whales" campaign. Defined Contribution (DC) plans of the 401(k) type have taken precedence as the favored way of saving for retirement. The demise of DB plans has taken place over the thirty years since the passage of the Employee Retirement Income Security Act of 1974 and now the remaining DB plans face a struggle for survival in the wake of serious funding, investment and accounting issues. Employer-sponsors of DB plans, faced with the challenges posed by onerous funding regulations and complex accounting and tax issues, have chosen to abandon the DB plan concept as a result of the dominant management objectives of controlling corporate expenses and meeting short-term earnings targets, rather than ensuring the provision of a dependable source of income for retirees.

If national retirement policy is defined in terms of a commitment to providing adequate and dependable income to senior citizens in their post-employment years, then it is time to take decisive action to ensure that this commitment is realized in practice. Senior citizens face many financial risks, including longevity risk, inflation risk and investment risk. Social Security provides a basic first tier of retirement income. Employer-sponsored retirement plans of the DB or DC type provide the second tier of retirement security in terms of income or capital accumulation. The third tier is provided by individual savings efforts through individual retirement accounts and annuities.

The key questions to address are: How effective is this three-tier structure in providing adequate income for senior citizens? How much variation and risk is involved

in the actual experience of retirees compared to reasonable expectations? What corrective actions can be taken? There is now a need for a serious effort to revitalize the DB plan concept and save the pension plan whales before they all become beached and die. A first priority is to instill a sense of moral responsibility and obligation on employers to provide and maintain defined benefit pension plans as the cornerstone of retirement security for employees. Employees render years of service and commitment to employers during their most productive years and have a right to expect that employers will provide both current compensation during the active working years and deferred compensation, in the form of a defined benefit pension, for the post-employment years.

The next priority is the issue of funding. Employers want reasonable, stable funding levels and are averse to unduly volatile funding requirements. Recent years have seen the deleterious effects of the combination of complex funding rules, sharply dropping interest rates, and the erosion of market values of equities. Funding rules that require enhanced levels of funding in difficult economic times when typically interest rates are low, when equity values decline and when corporate expense budgets are under pressure, will be onerous for employer-sponsors and will be counterproductive to the maintenance of DB plans. Conversely, funding regulations that restrict the amount of funding in strong economic periods when corporate budgets are better able to make increased pension fund contributions, are also counterproductive. A much-simplified system of pension funding is urgently needed. A controlled funding system that generates stable year-to-year pension contributions is not difficult to construct. Funding targets need to be clearly established, whether on a going-concern basis

or on a discontinuance basis. The determination of asset-to-liability funded ratios on both an ongoing basis and discontinuance basis, and using asset values on a mark-to-market basis, should be a routine procedure. Funding practices should be simplified so as to ensure that 100% funding of assets-to-liabilities is achieved over a specified number of years with a stable level of funding. Existing funding regulations and accounting rules need to be replaced in their entirety.

Finally, investment strategy for DB plans needs to be reassessed in terms of the underlying nature of pension liabilities, their incidence, duration and interest-rate sensitivity. Some pension funds are managed by asset managers with an "asset-only" outlook whose strategy is focused exclusively on investment rates of return without regard to the all-important asset-liability relationship. Other pension funds are managed on the basis of a broad asset allocation mandate and are not sufficiently sensitive to the incidence and duration of liabilities or the extent to which liabilities are sensitive to interest rate changes. The recent experience of pension funds with very high equity exposure during a prolonged and deep three-year bear market for equities has clearly demonstrated the need for a closer look at the role of equities in pension fund investment strategy and the potential advantages to be gained from fixed income investment in bonds and other types of non-equity securities.

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