
From: jeffrey.kamenir@milliman.com [mailto:jeffrey.kamenir@milliman.com]
Sent: Tuesday, February 16, 2010 4:42 PM
To: EBSA, E-ORI - EBSA
Subject: Department of Labor- RFI Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans - RIN 1210-AB33

In response to the above RFI, I am providing below a copy of an article written by me that was published last year. The article is entitled "How to Make Defined Benefit Pension Plans Attractive to 21st Century Employers".

In general, the article is about a possible new type of defined benefit pension plan system that employers might consider sponsoring since it is designed to minimize annual cost volatility and have much simpler rules than the current system. The possible new system is geared completely toward providing participants with a lifetime monthly pension income payable directly from a defined benefit pension plan.

I believe the article addresses question B.14 of the RFI and touches on various other RFI questions.

Please keep in mind that the article represents my ideas and opinions and does not represent the ideas and opinions of my company.

Jeffrey R. Kamenir, ASA, MAAA, EA
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----- Forwarded by Jeffrey Kamenir/CHIC/MILLIMAN on 02/16/2010 03:20 PM -----

Fw: Author copy of Jeff Kamenir article

Jeremy Engdahl-Johnson

to: Jeffrey Kamenir

06/01/2009 05:25 PM

Jeff,

Here you go.

----- Forwarded by Jeremy Engdahl-Johnson/NYRK/MILLIMAN on 06/01/2009 06:27 PM -----

Sandy Becker <Sandyb@ifebp.org>

To: Jeremy Engdahl-Johnson <jeremy.engdahl-johnson@milliman.com>

cc

06/01/2009 04:37 PM

Subject RE: Author copy of Jeff Kamenir article

Hi Jeremy -

Here you go. Call on me at any time if I can be of assistance. Have a great evening.

Sandra L. Becker, CEBS
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From: Jeremy Engdahl-Johnson [<mailto:jeremy.engdahl-johnson@milliman.com>]
Sent: Thursday, May 28, 2009 5:48 PM
To: Sandy Becker
Subject: RE: Author copy of Jeff Kamenir article

Great. Thanks, Sandy.
Jeremy

Sandy Becker <Sandyb@ifebp.org>
05/28/2009 06:28 PM
To
Jeremy Engdahl-Johnson <jeremy.engdahl-johnson@milliman.com>
cc

Subject
RE: Author copy of Jeff Kamenir article

Hi Jeremy
We'll get it made up and send it out to you Friday or Monday.

Thanks

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From: Jeremy Engdahl-Johnson [<mailto:jeremy.engdahl-johnson@milliman.com>]
Sent: Thursday, May 28, 2009 12:24 PM
To: Sandy Becker
Cc: Jeffrey Kamenir
Subject: Author copy of Jeff Kamenir article

Sandy,

Is it possible to get a PDF of Jeffrey Kamenir's article, "How to make defined benefit plans attractive to 21st Century employees?"

Thanks for your help,
Jeremy

Jeremy Engdahl-Johnson
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How to Make Defined Benefit Pension Plans Attractive to 21st Century Employers

by Jeffrey R. Kamenir

It is highly unlikely that many new defined benefit (DB) plans will be established under the current DB plan system, which is unfortunate given a DB plan's ability to provide retirees with predictable retirement income that will not run out. This article provides a blueprint for what could be a sustainable new DB plan system. The goal is to devise a new DB plan that will experience less cost volatility, the hope being that if plan sponsors know that costs will be stable from year to year, they may be more inclined to sponsor a DB plan (or keep one going).

The main reason many companies no longer wish to sponsor defined benefit (DB) pension plans, or establish new ones, is the year-to-year cost volatility they present. Largely, this volatility is caused by two variables. The first is the unpredictable nature of annual investment performance. The other is the unpredictability of changes in the long-term interest rates used to value plan liabilities. The DB plan structure proposed here would address both of these sources of uncertainty and resulting cost volatility.

Implicit in this new DB system is the idea that plan sponsors would have to expect a lower investment return on assets, which in turn would mean that higher contributions would be required and/or lower benefits provided when compared with the current DB system. (See sidebar: "Comparison of Costs and

Benefits Under New DB Plan System and Current DB Plan System.")

Nevertheless, companies might accept this trade-off in exchange for much greater cost stability and a major simplification of the rules governing DB plans.

PROPOSED NEW DB PLAN SYSTEM

The new DB plan structure proposed here would be based on the following "big picture" rules:

1. Plan sponsor contributions would be invested in vehicles such as money market accounts, where the principal value is designed to remain stable.

2. The value of all plan liabilities would be calculated using a mandated stable asset-type interest rate assumption published by the Internal Revenue Service (IRS).

3. Minimum required contributions would be annually determined, based on the sum of any un-

COMPARISON OF COSTS AND BENEFITS UNDER NEW DB PLAN SYSTEM AND CURRENT DB PLAN SYSTEM

An employee hired at the age of 45 immediately begins participation in a DB plan under the current system. The plan's investment allocation of stocks and bonds is expected to result in an annual investment return of 7.5%. The plan provides an annual lifetime benefit payable beginning at the age of 65 based on a formula of 3% of pay for each year worked. If the employee works until the age of 65 and has an average annual pay of \$50,000, the employee's annual lifetime benefit beginning at the age of 65 is equal to \$30,000 (i.e., $3\% \times \$50,000 \times 20$ years). Based on the plan's expected investment return, the company will need to contribute about \$6,000 per year for 20 years to fully fund the benefit when it starts at the age of 65.

Under the new DB plan system, the plan's investments are all allocated instead to stable assets, such as money market accounts, which are expected to earn an annual investment return of 4%. Based on this lower expected investment return, the company will need to contribute instead about \$12,000 per year for 20 years to fully fund the same \$30,000 annual lifetime benefit commencing at the age of 65. Alternatively, if the company wants to contribute only \$6,000 per year for 20 years, the employee's annual lifetime benefit beginning at the age of 65 would be equal to \$15,000 based on a reduced formula of $1.5\% \times$ pay for each year worked.

Although the current DB plan system in this example is expected to produce either greater benefits for the same cost or the same benefits for lower costs, the trade-off is that the company will be exposed to much more annual cost volatility due to the more aggressive investment allocation. Under the current DB system, the company's periodic problem is that some years the "expected" investment return does not materialize, or might even be a loss. Then the company has to figure out how to make up the difference.

funded accrued-to-date liability and the liability expected to be accrued in the coming year.

4. Minimum required contributions would not need to be paid in quarterly installments.

5. All plan sponsor contributions would become part of the plan's assets and would be fully deductible, including any contributions over and above the minimum required contribution.

6. Unfunded accrued-to-date liabilities would be determined based on the market value of assets.

7. Pension expense for accounting purposes would be equal to contributions made with no further balance sheet disclosure required.

8. Plan benefits would not be insured by the federal government, so Pension Benefit Guaranty Corporation (PBGC) premium payments would no longer be required.

9. All plan benefits would be paid as monthly annuities.

10. The plan sponsor would select the plan design desired, subject to current nondiscrimination testing rules.

11. Contributions would continue to be reported on IRS Form 5500.

Table I summarizes what the general differences

would be between this proposed new DB plan system and the current DB plan system.

TRANSITION OPTION FOR EXISTING DB PLANS

All existing DB plans would have the option to convert to the new DB plan system by transferring all plan assets into an investment vehicle that cannot lose principal and fully funding the plan's unfunded accrued-to-date liabilities at the date of transition.

COMPARING DB PLANS TO MONTHLY ANNUITIES OFFERED BY DEFINED CONTRIBUTION (DC) PLANS

Although it is possible (or required in certain plan designs) to offer monthly annuities as payout options in a DC plan, it is much more difficult to do so than in a DB plan. If account balances are converted to monthly annuities within a DC plan (i.e., without purchasing an annuity), it is possible that a participant can outlive the account balance, resulting in the monthly annuity eventually becoming equal to \$0. If account balances were converted to monthly annui-

TABLE I**NEW DB PLAN SYSTEM VERSUS CURRENT DB PLAN SYSTEM**

Proposed New DB Plan System	Current DB Plan System
<ul style="list-style-type: none">• Mandated investment allocations to stable asset funds, such as money market accounts, with low risk of loss of principal	<ul style="list-style-type: none">• Investment allocation, determined by plan sponsor (typically a mix of stocks and bonds), can lose principal with unpredictable and volatile investment performance.
<ul style="list-style-type: none">• Mandated interest rate assumption used to determine liabilities, annually updated, based on stable asset interest rates (e.g., money market accounts)	<ul style="list-style-type: none">• Mandated interest rate assumption used to determine liabilities, annually updated, based on corporate bond interest rates
<ul style="list-style-type: none">• Proposed rules same as current rules, which require more recent mortality tables to be used to value liabilities but allow all other assumptions to be based on a plan's particular demographic experience	<ul style="list-style-type: none">• Mandated mortality rate assumption used to determine liabilities, annually updated. All other actuarial assumptions (e.g., salary increases, termination, retirement, disability) are selected by the enrolled actuary.
<ul style="list-style-type: none">• Minimum required contribution annually equal to sum of unfunded liability to date (including any liability related to past service in the initial actuarial valuation), plus liability expected to be accrued in the following year. This is more likely to result in a plan being fully funded, which minimizes annual contribution volatility.	<ul style="list-style-type: none">• Minimum required contribution annually equal to seven-year amortization of unfunded liability to date, plus liability expected to be accrued in following year. This is less likely to result in a plan being fully funded, which makes annual contribution volatility more likely.
<ul style="list-style-type: none">• Minimum required contribution is payable by the end of the plan year.	<ul style="list-style-type: none">• Minimum required contribution is payable in four quarterly installments with a final payment due by 8½ months after the end of the plan year. This payment system can be confusing to plan sponsors due to complex rules governing quarterly contribution requirements.
<ul style="list-style-type: none">• Funding greater than the minimum required contribution is always included in plan assets without any negative consequences.	<ul style="list-style-type: none">• Funding greater than the minimum required contribution is considered a "credit balance" that can be used to reduce future minimum required contributions. However, complicated rules require the "credit balance" be excluded from plan assets in many circumstances, which can result in a plan being considered less funded and subject to additional compliance requirements.
<ul style="list-style-type: none">• All contributions are fully deductible, which gives plan sponsors maximum flexibility. Proposed excess asset rules are the same as the current rules, which are designed to discourage employers from gaming their tax situation.	<ul style="list-style-type: none">• Contributions subject to maximum deductible limit, which can result in a plan sponsor contributing an amount less than desired (although this is now likely to be less of a concern because recent legislation is expected to increase the maximum deductible limit). Excess assets at plan termination are subject to regular and excise taxes.
<ul style="list-style-type: none">• Unfunded liabilities are based on market value of assets, which results in any small investment losses being immediately funded.	<ul style="list-style-type: none">• Unfunded liabilities can be based on "smoothed assets," which can delay funding of any investment losses.

TABLE I (continued)

NEW DB PLAN SYSTEM VERSUS CURRENT DB PLAN SYSTEM

Proposed New DB Plan System

Current DB Plan System

<ul style="list-style-type: none">• Pension expense on company income statement is annually equal to contributions made, which results in a stable company balance sheet due to there being no differences between pension expense and contributions. Unfunded projected liabilities are not annually disclosed, which further stabilizes the annual company balance sheet.	<ul style="list-style-type: none">• Pension expense on the company income statement is annually determined in accordance with an accounting standard that may result in annual company balance sheet volatility due to differences between pension expense and contributions made. Unfunded projected liabilities are annually disclosed in accordance with an accounting standard, which further increases annual company balance sheet volatility.
<ul style="list-style-type: none">• Benefits not insured by federal government, so no annual insurance premium payments and no special filings are required.	<ul style="list-style-type: none">• Annual premium payments required by plan sponsor to federal government, which insures majority of plan benefits in the event of a funding default. However, healthy plan sponsors with reasonably funded plans dislike paying annual premium payments, since there is little chance of a plan default occurring. Poorly funded plans are required to do special filings with the Pension Benefit Guaranty Corporation.
<ul style="list-style-type: none">• All benefits paid as monthly lifetime annuities helping ensure that participants will not outlive their retirement income. All monthly payment options would be "actuarially equivalent."	<ul style="list-style-type: none">• Retirement benefits can be paid as one-time lump sums rather than monthly annuities (subject to compliance with benefit restriction rules that complicate plan administration). This requires participants to make investment and distribution decisions about their postretirement income. All payment options may not be "actuarially equivalent," which requires plan sponsors to provide participants with complex "relative value" comparisons for each option.
<ul style="list-style-type: none">• Proposed rules same as current rules, which attempt to minimize disparity in benefits between lower paid and higher paid participants.	<ul style="list-style-type: none">• Plan design selected by plan sponsor. If a "safe harbor" plan design is selected, nondiscrimination testing is not required.
<ul style="list-style-type: none">• Proposed rules same as current rules, protecting participants by requiring that an enrolled actuary certify annual minimum funding requirements are satisfied and to communicate annually the funded status of the plan.	<ul style="list-style-type: none">• Contributions annually reported on IRS Form 5500 and annual funding notice given to participants.
<ul style="list-style-type: none">• Since annual asset and liability values are not expected to be volatile under the proposed rules, a formal actuarial valuation may not be necessary every year.	<ul style="list-style-type: none">• Formal actuarial valuation is required annually.
<ul style="list-style-type: none">• As with the current rules, plan sponsors have the option to purchase annuities from an insurance carrier rather than pay monthly benefits from plan assets. Cost of paying monthly annuities from the plan is not expected to be materially different from an annuity purchase, due to the use of conservative assumptions for valuing plan liabilities.	<ul style="list-style-type: none">• Plan sponsors have the option to pass on investment and mortality risks to insurance carriers via an annuity purchase. Cost of paying monthly annuities from the plan is not expected to differ materially from an annuity purchase, due in part to recent legislation further mandating the assumptions used to value plan liabilities.

AN EXISTING DB PLAN WITH ELEMENTS OF THE PROPOSED NEW DB PLAN SYSTEM

General Information on DB Plan

- Public sector DB plan established in 1974
- 350 participants (225 active and 125 inactive)
- \$16 million in assets
- 100% of assets invested in stable insurance company vehicle
- Benefit formula generally 1.5% times final average pay times years of service
- Normal retirement generally age 62
- Early retirement generally age 60
- Early retirement benefits “actuarially equivalent” to normal retirement benefits
- Various monthly forms of payment options are offered and are all “actuarially equivalent.”
- No lump-sum option is available.
- No employee contributions are required.

TABLE II
FINANCIAL SUMMARY OF DB PLAN

Year	Previous Year Gross Investment Return	Funded Ratio* At Beginning of Year	Contribution for Year (% of Payroll)***
1994	6.89%	129%	9.1%
1995	5.18	127	9.2
1996	6.40	125	9.8
1997	8.55	131	9.3
1998	7.96	132	9.3
1999	7.70	128	10.1
2000	7.28	130**	11.0
2001	7.22	140**	9.8
2002	7.00	142**	10.3
2003	5.92	140**	12.3
2004	5.63	142	7.7
2005	5.55	139**	11.8
2006	5.97	131	12.2
2007	5.55	130**	14.3
2008	5.41	121**	14.9

* Funded ratio is equal to the market value of assets divided by accrued-to-date liabilities. Accrued-to-date liabilities were valued using a 7.5% interest rate for years 1994 through 2005, a 7.0% interest rate for 2006 and 2007, and a 6.5% interest rate for 2008.

** Reflects benefit improvements

*** For governmental accounting purposes, pension expense each year is equal to contributions made for each year.

ties in a DC plan by annuity purchases, monthly benefit amounts would be subject to unpredictable insurance carrier pricing. Plan sponsors would be responsible for ensuring that the chosen carrier is unlikely to default on the monthly benefit contract with the participant.

Assuming a plan sponsor is willing to provide a monthly annuity option within a DC plan, despite the possible administrative issues mentioned above, it could provide a monthly annuity similar to that provided under the proposed new DB plan system. The company would have to be willing to assume investment responsibility for the account balances and invest the money in similar stable asset vehicles. However, in today's DC plan world, many companies prefer to give participants the investment responsibility for their account balances. Many participants prefer to make their own investment decisions, opting for a lump-sum distribution rather than a monthly annuity.

It therefore seems unlikely that a company would design a DC plan to be similar to the new DB plan proposed here. A more feasible possibility for companies desiring to control cost volatility and still provide some type of retirement "safety net" to participants via a monthly annuity might be to adopt the proposed new DB plan as a supplemental benefit to a primary DC plan.

AN EXISTING DB PLAN WITH ELEMENTS OF THE PROPOSED NEW DB PLAN SYSTEM

The author has been a consulting actuary for nearly 15 years for an existing DB plan that has elements of the proposed new DB plan system. (See sidebar: "An Existing DB Plan With Elements of the Proposed New DB Plan System.") This plan is an example of how it is possible to achieve cost stability while also providing meaningful benefits to plan participants and maintaining a strong funded status. Because the plan is in the public sector, it is not burdened by complex rules that inhibit funding and plan administration, nor by accounting requirements that produce pension expenses that differ from actual funding.

It is possible to implement some of the proposed DB plan system concepts under the current private sector DB plan system, such as allocations to more stable investment alternatives and adoption of a contribution policy that annually results in a well-funded position. However, for the proposed system to become a reality, the balance of the system's ideas would require rule changes to the current system.

CONCLUSION

Under the current DB plan system, it is highly unlikely that many new DB plans (other than perhaps "tax-shelter" plans for small professional groups) will be established. Many plan sponsors would like to avoid being subjected to the yearly cost volatility that comes from unpredictable annual investment performance and long-term interest rate variance. As a result, the DC retirement plan has been the wave of the recent past and present.

However, if a new type of simple DB plan system, such as the one proposed in this article, could be created via a fresh pension legislative initiative and approved by the group in charge of pension accounting standards, it would go a long way toward again making DB plans a viable alternative for employers. The author believes that the continued survival of DB plans is extremely important, given a DB plan's ability to provide retirees with predictable retirement income that will not run out, even when a retiree has the good fortune to live a long life. ◀

▶ THE AUTHOR

Jeffrey R. Kamenir has 25 years of experience in consulting with clients on a wide range of retirement benefit issues including plan design, funding, accounting, compliance and communications. He has extensive experience dealing with various issues related to defined benefit plans. Kamenir's consulting experience includes actuarial valuations, asset/liability forecasts, benefit change studies, plan terminations, compliance with nondiscrimination requirements and funding policy development.

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