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Executive Summary

Defined benefit (DB) pension plans have long been meaningful for a secure retirement. The characteristics of broad-based participation, lifetime income streams that cannot be outlived, and ancillary benefits such as spousal and disability protections make them very important to maintaining a pre-retirement standard of living. However, in recent years, more and more employers have been seeking to de-risk their pensions. De-risking strategies can take many forms, from changing asset allocation strategies, to offering lump sum distributions, making annuity purchases, freezing benefits, even terminating plans entirely.

Plan sponsors have been seeking such strategies in order to minimize volatility of contributions and increase the predictability of plan funding. Communications Workers of America (CWA) employers have adopted many of these strategies in recent years, and the trends continue. Even our largest and most profitable employers have pursued strategies including reducing benefits drastically, freezing accrual rates, and eliminating new hires from coverage.

Another de-risking strategy that has been adopted recently is purchasing annuity contracts for retiree pension obligations. Steps may be taken to better protect participants in the wake of such a transaction. First, plan sponsors can be required to issue a formal notification to all plan participants, at least 90 days before the transaction takes place. Second, it should be mandated that an independent fiduciary be hired, to ensure the best interest of plan participants. Third, it should be required that a plan be above a certain funded level before it may pursue such a transaction, and it should be mandated that no plan funds be used to finance the transfer over and above the value of the obligations being sold.

CWA believes that freezing benefits, annuity contracts, and other such de-risking strategies are not in the best interest of plan participants. Alternative options exist that would offer companies the opportunity to minimize risk in their pension plans, while still offering quality benefits to employees.

For example, the Adjustable Pension Plan (APP) is designed to share risk between employees and employers more broadly. By enabling the benefit to adjust year to year and adopting a more conservative asset allocation, the design minimizes pension expense volatility in financial statements and provides for more stability and predictability in contribution requirements, making it attractive to employers with de-risking motivations. At the same time, the APP also benefits employees, as it maintains DB elements that offer better protections from risk, including professional asset management and automatic annuitization in retirement.

Defined Benefit (DB) Pension Plans Are Highly Beneficial to Employees

Research has long shown that traditional defined benefit (DB) pension plans make sense for most Americans. DB plans offer middle-class Americans secure retirement benefits, which help to ensure that they maintain their living standard into retirement.

Prior to joining CWA, I spent four years as a researcher at the National Institute for Retirement Security, a nonprofit, nonpartisan organization whose mission is to contribute to informed policymaking by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole. To this end, I conducted substantial research on the role of traditional, defined benefit (DB) pension plans.

In my experience, it is quite clear that very specific characteristics of traditional DB pension plans make them very effective at supporting retirement security for the middle class. First and foremost, DB pensions provide a lifetime income stream that cannot be outlived. Also, DB pensions feature broad-based participation, in which all vested employees receive a benefit. Finally, DB pension plans provide ancillary benefits such as spousal protections and disability benefits. Together, these DB pension characteristics are quite effective at helping to ensure a secure retirement income for Americans who have these plans.

More and more research confirms this. A 2008 Ernst & Young study found that the trend away from DB pensions and into DC plans in the private sector is having a negative effect on retirement prospects for many newly retired Americans, and that those with guaranteed lifetime income from DB pensions are much better prepared for retirement than those without such income. Among married couples with an income of $75,000 before retirement, for example, those without DB income have a 90% chance of outliving their assets in retirement, as compared to just 31% of those with DB income. The study further finds that new middle-class retirees without DB pension income will have to reduce their standard of living by an average of 32% in order to avoid outliving their assets in retirement.[i]

Among early Baby Boomers (born 1946-1954), Boston College researchers find that 35% are "at risk" of falling more than 10% short of achieving a target replacement rate designed to maintain a pre-retirement standard of living. This number is not only much larger for those with income only from DC plans and for those with no retirement plan, but there is also virtually no difference in the retirement risk of those with DCs and those with no retirement plan—49% versus 50%, respectively. Among households with DB pensions, however, these numbers drop significantly—to 15% for those with just a DB pension, and 12% for those with both DB and DC income. The study finds similar trends among Late Boomers (born 1955-1964) and Gen Xers (born 1965-1972) as well.[ii]

Also, the Government Accountability Office recently studied participants in DC-only retirement plans and their account balances, and used this data to project the retirement prospects of these workers. The results showed that a full 37% of workers born in 1990 may enter retirement age with no retirement savings at all, while a full 63% of Americans in the lowest income quartile are projected to have zero retirement savings. Those in the highest income quartile fare best, but are still projected a replacement ratio of just 34% of preretirement income on average from their DC plan.[iii]

Finally, the National Institute on Retirement Security recently found that DB pension income plays a substantial role in ensuring that Americans remain self-sufficient in retirement. Specifically, the study found that DB pension receipt was associated with 4.7 million fewer poor and near-poor households in 2010 (as defined by the Federal Poverty Level). As a result, 460,0000 fewer households reported experiencing a food hardship, 500,000 fewer reported a shelter hardship, and 510,000 fewer reported a health care hardship due to their DB pension income. This increased financial independence means fewer older Americans relying on public assistance programs. The study finds that in 2010, an additional 1.22 million older American households would have been added to the rolls of means-tested public assistance programs without receipt of their pension income.[iv]

Each of these studies shows the specific importance of DB pension income in maintaining a middle- class standard of living in retirement and avoiding hardships.

Defined Benefit (DB) Plan Sponsors Have Been De-Risking Pensions in Many Ways

Yet despite the positive aspects of pensions, in recent years, it has become increasingly difficult for employees to hold onto traditional pension benefits. Since the early 1980s, the number of private sector DB plans has markedly decreased, as has the number of workers who are covered by a DB plan. For example, in 1975 88% of private sector workers covered in a workplace retirement plan had DB coverage; by 2005, this number dropped to just 33%.[v] Also, in 1985 there existed over 112,000 single-employer DB plans in the United States, but by 2010, there were just over 26,000.[vi]

As a research economist for the Communications Workers of America (CWA), a trade union representing over 700,000 men and women working in a variety of industries in both private and public sectors, my primary role is bargaining and policy support as related to pension and retirement issues, and these trends of pension decline are quite apparent.

Pension de-risking strategies can take many forms, from changing asset allocation strategies, to offering lump sum distributions, making annuity purchases, freezing benefits, even terminating plans entirely.

My remarks will focus on those strategies that we have seen recently at the CWA, where we have experienced unprecedented cutbacks in retirement benefits for our employees—even among very large, profitable companies. For example, in the last round of bargaining, one of CWA's largest, most profitable employers insisted on major retirement cutbacks from employees. This included freezing the traditional pension plan for all new hires, and partially freezing accruals for active employees. This despite the fact that the company has been very profitable, and the pensions were relatively well-funded in the wake of the financial downturn. At one subsidiary, the pension plan was over 200% funded, and as a result the company had not made a pension contribution in several years—yet benefits were still frozen, and new hires excluded.

Another large CWA employer has been systematically decreasing its retirement benefit generosity for many years now, first moving from a traditional pension to a cash balance design, and then moving to an even less generous cash balance plan just a few years later.

Many of our smaller employers have been "pension de-risking" in these ways for many years—eliminating pensions for new hires and freezing current employee accruals. In addition to these more traditional ways to de-risk pension obligations, more CWA employers have also recently undertaken alternative de-risking strategies.

For example, another large CWA employer recently announced an agreement to transfer pension assets representing the obligations of tens of thousands current retirees in the management pension plan to an insurance company. The liabilities included in the transfer represent approximately 25% of the company's total pension obligations. CWA-represented employees were not included in the asset transfer. However, such a transaction may be detrimental to participants—both those whose liabilities are transferred as well as those remaining in the pension plan.

Regarding those participants whose obligations are transferred, once the liabilities are sold, the plan sponsor holds no more fiduciary duty. The sponsoring insurance company holds all responsibility to pay benefits. Should the insurer experience financial difficulty and an inability to pay, participants' benefits would not be protected by the Pension Benefit Guaranty Corporation (PBGC), as they would be if the original sponsor still held the obligations. Instead, benefits are backed solely by state guaranty associations (SGAs). Yet the guarantees of SGAs are not remotely equitable to the PBGC protection. While the PBGC guarantees benefits up to $57,000 per year at age 65,[vii] SGAs only guarantee a maximum of $100,000 to $500,000 lifetime lump-sum cash out equivalent,[viii] a far lower guarantee for participants. Also, such state by state variability in the maximum guarantee bring into question equity issues—among two plan participants receiving the same exact level of pension benefit, one participant can have a benefit guarantee that is five times greater than that of the other, just as a result of residing in a different state.

In addition, SGAs are not prefunded. If an SGA becomes required to pay benefits, it must obtain the necessary assets by assessing a fee on member insurers that write the same kind of business as the insolvent insurer. Only these fees and the insolvent insurer's remaining assets are used to pay participants' benefits.[ix]

Regarding those participants who remain in the company-sponsored plan, to the extent that the plan was at all underfunded before the liability transfer, it will become even more underfunded simply as a result of the transaction, absent a large cash infusion into the plan. This is especially problematic because current rules require that if a plan is less than 80% funded, certain benefit restrictions must go into effect. For example, no benefit increases may be granted, and any lump sum benefits are limited to 50% of the value of a retiring employee's pension benefit. Under 60% funding, the plan must freeze benefit accruals, and all lump sum payouts are prohibited.[x] In this way, a lower funding level for the existing plan brings up equity issues for those participants remaining in that plan.

Thus, such liability transfers mean that those whose obligations are sold lose key benefit protections, and those whose are not sold may see their plan in a worse financial condition as a result of the transfer.

In the event of such a liability transfer, there are several actions that could be taken to better protect participants. First, a plan sponsor seeking to make an annuity transfer can be required

to issue a formal notification to all plan participants, at least 90 days before the transaction takes place. The notification should fully disclose the plan sponsor's intentions regarding the transaction, which participants would likely be affected, the ways in which their benefits may be affected, and how the transaction may affect the remaining plan's finances. This would better ensure that participants are informed, well in advance, of any effects that such a transfer would have on their benefit. For example, those participants whose benefit are likely to be transferred should fully understand that they will be losing PBGC protections and that their benefits are now guaranteed by their individual state SGA, whose provisions and guarantee limits can vary widely. Those participants whose benefits remain in the existing plan should be informed that the plan's funded status could fall as a result of the transfer, and what that may mean in terms of any resulting benefit restrictions or increased contribution requirements.

Second, the Department of Labor currently lays out the fiduciary considerations that plan sponsors must consider in the event of an annuity transfer; where the fiduciary does not have the expertise needed, and/or where possible conflicts of interest may arise, the DOL suggests that that plan obtain and follow independent expert advice.[xi] As a result, many plan sponsors have hired an independent fiduciary to oversee the transaction. CWA believes that in order to ensure that the highest quality insurer is chosen, and avoid any potential conflicts of interest, the hiring of an independent fiduciary should be made a requirement.

Finally, it should be required that a plan be above a certain funded level before it may pursue such a transaction. For example, the plan must have an Adjusted Funding Target Attainment Percentage (AFTAP) of at least 85% before it may transfer any assets out of the plan in order to fund an annuity purchase—and that it must remain at least 80% funded after the transaction. This would better ensure that those participants who remain in the existing plan would not be subject to benefit restrictions as a result of a decline in the plan's funded status, as discussed above. In addition, in recognition of the fact that the plan sponsor will pay a premium to the insurer through the transaction, it could be mandated that no plan funds may be used to finance the transaction over and above the value of the obligations being sold. This is in light of the fact that the transaction is voluntary on behalf of the company, and therefore it should not jeopardize the finances of the remaining plan.

In addition, the de-risking strategy to offer of a lump sum buy-out to deferred vested participants and retirees in pay status—as several large automobile manufacturers have recently utilized—could result in similar financial concerns for the remaining plan participants. As such, these same financial requirements could also be stipulated for lump sum buy-out scenarios as well, in order to better protect the remaining participants for the same reasons noted above.

Many Employers Seek to De-Risk in Order to Minimize Contribution Volatility

There are several reasons why plan sponsors have been seeking to de-risk in recent years. Research has found that significant changes to single-employer DB plans in the last three decades have had the unintended effect of making the DB plan less attractive to many employers—and more likely to seek de-risking strategies, if not complete terminations. Several legislative acts in the 1980s[xii] to the Pension Protection Act of 2006 (PPA)[xiii]—were increasingly complex, resulting in more complicated funding rules[xiv] and increasing contribution volatility. Such volatility has been burdensome to employers, who would prefer to have steady, easily estimable costs from year to year.

In 2008 the Government Accountability Office (GAO) conducted a survey of private plan sponsors who have frozen their DB plans. It found that the two most common reasons for companies to freeze their plans were the impact of annual contributions on the firm's cash flows and the unpredictability of plan funding.[xv] It is important to note that these plan sponsors did not cite the outright cost of the DB plan as a problem—rather, of concern was the cost's impact on cash flow. A December 2010 Towers Watson survey found comparable results among current DB plan sponsors; the three top concerns of DB plan sponsors over the next five years were impact on cash flow, impact on the income statement, and impact on the balance sheet.[xvi] A 2003 Hewitt survey has similar findings—that employers perceive cost volatility as the single greatest threat to the DB pension system.[xvii]

Certain De-Risking Alternatives Can Better Protect Participants

CWA recognizes the challenges that employers face in maintaining traditional pension plans, especially in an increasingly competitive economy and low interest rate environment. Absent a national standard to offer any workplace retirement plan, those employers that choose to maintain a traditional pension do face additional cost considerations, and thus may seek to de-risk their plans. At the same time, we also understand that certain de-risking strategies are more potentially detrimental to plan participants than others—especially actions such as freezing benefit accruals, not covering new hires, and annuity transfers.

Alternative strategies can be adopted that both minimize pension funding risk for the employer while also maintaining quality DB pension benefits for workers, which is so critical to their retirement security.

For example, a large CWA employer recently announced its intention to contribute to its pension plan a large preferred equity interest of its own stock. The company is currently seeking approval from the Department of Labor (DOL) in order to make such a transaction. The equity contribution will eliminate its need to make a cash contribution in 2013, and will pay down nearly the entire value of the current unfunded liability of the pension plan.

Although the CWA stands by the asset allocation standards that currently exist, and believes that such an infusion of company stock would not be appropriate for many employers, we also acknowledge that exemptions may be granted in limited cases, based on the projected financial prospects of the company in question, and the finances of its existing pension plan.

Thus, in this particular instance, the CWA supported this transaction, because the company is extremely profitable, and the stock contribution would be from the part of its business that is growing the fastest. We believe that the company is showing confidence that it will continue to grow, while at the same time making a commitment to strengthen its pension plan.

Another option could be something akin to the Adjustable Pension Plan (APP) design. The APP is designed to create more of a partnership between employer and employees by sharing investment risk and moving towards a lower risk investment pool. The plan design is somewhat unique in that an agreed-upon target contribution rate is set first. Conservative assumptions are used, and a more conservative asset allocation is targeted, in order to provide more certainty that the plan will stay fully funded. A target benefit level is set, but benefits for

active employees are adjusted each year based on the performance of the fund, which provides for greater stability of contributions.

The APP should be an attractive option to employers seeking to de-risk its pension obligations. By enabling the benefit to adjust year to year, and adopting a more conservative asset allocation, the design minimizes pension expense volatility in financial statements and provides for more stability and predictability in contribution requirements. Thus, it is also more likely to stay 100% funded than most traditional DB structures.

At the same time, APP is also attractive to employees, especially as compared to a defined contribution (DC) plan. Since the APP is a defined benefit plan under ERISA, benefits are guaranteed by the PBGC, and generally financed by the employer. Thus, the guesswork of contribution rates, investment options, and draw-down in retirement is eliminated for employees. The plan—and employees—gain the benefit of pooled, professional asset management, which leads to higher investment performance and lower fees than typical DC plans.[xviii] Also, employees' benefits are automatically annuitized in retirement, so that they are guaranteed a monthly paycheck that they cannot outlive.

The CWA has successfully bargained the APP into two recent contracts. In both cases, the employer was initially unwilling to continue DB coverage, and was only interested in DC options. Yet upon learning about the APP model, they saw that such a plan design offered substantial risk mitigation and reduced volatility in funding costs, while at the same was highly valued by employees.

Indeed, our represented employees seem to understand this trade off. While their benefit may be less generous than a more traditional pension design, the APP offers better protections than a DC plan, in which they would face significantly more risk exposure.

Thus, in an environment in which companies seek to de-risk their retirement obligations in numerous ways, we believe that an array of options exist that can both minimize pension funding volatility while still providing quality DB benefits for employees, to whom traditional pension benefits are still so important.

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