AMERICAN ACADEMY *of* ACTUARIES

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Retirement for the AGES Assessment

Forward Thinking Task Force

Traditional Defined Benefit Plan Under Current System

Grade: C+

This assessment is based on a traditional single private employer defined benefit plan with the following features:

- A defined eligibility and automatic entry
- Benefit equal to 1.5% of final average pay for each year of service
- Can be coordinated with Social Security
- No employee contributions
- Five-year vesting
- Subsidized early retirement benefits
- Disability and pre-retirement death benefits
- No lump-sum option
- The employer's board of directors is responsible for governance but delegates authority for plan administration and investment to board and/or executive committees with appropriate expertise.

Traditional Defined Benefit Plan Under Current System

Alignment

B+

Description

- Aligns each stakeholder’s role with their skills.
- Redefines employer’s role by placing responsibility for important roles with those appropriate entities.
- Helps individuals by structuring their choices to be well-defined and enhance good decision-making.
- Develops systemic ways to enhance financial security through appropriate levels of laws and regulations.

Application of Principles

+ Employees earn benefits for retirement without any action on their part.

+ Benefits are paid as lifetime income.

+ Employer can use plan as workforce-management tool.

+ Federal law provides safeguards to protect the security of plan beneficiaries (e.g., Pension Benefit Guaranty Corporation guarantees).

- Increases in complexity for plan administration and regulation can be a distraction from employer’s core business.

* The plan is managed by the employer, and relevant expertise may or may not be available.

Legend
(+) feature meets principles
(-) feature does not meet principles
(*) feature where there is not enough information to determine impact or actual impact may depend on stakeholder actions

Traditional Defined Benefit Plan Under Current System

Efficiency

A-
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Description

- Allows smaller plans to group together, with standard and transparent fees to lower plan costs.
- Provides consistent opportunities to accumulate assets during working lifetime to enhance participation and coverage.
- Minimizes leakage for non-retirement benefits during accumulation and payout phases.
- Encourages pooling and effective risk sharing so funds can provide lifetime income.
- Incents narrowing the variability of benefits by fostering risk hedging and allowing for pricing benefits and guarantees.

Application of Principles

+ The pooling of the longevity risk is provided by the employer.

+ Limited opportunities for leakage with annuity option.

+ Benefits and guarantees can be priced.

+ Professional or institutional management provides more efficient asset management at a lower cost.

- Limited ability for smaller plans to group together and pool risks.

Legend
(+) feature meets principles
(-) feature does not meet principles
(*) feature where there is not enough information to determine impact or actual impact may depend on stakeholder actions

Traditional Defined Benefit Plan Under Current System

Governance

C-

Description

- Clearly defines roles and responsibilities, and acts in accordance with them.
- Reduces real and potential conflicts of interest.
- Recognizes and manages competing needs.
- Staffs boards with financial and other professionals who possess relevant expertise.

Application of Principles

+ Employee Retirement Income Security Act (ERISA) provides certain safeguards to participants.

+ ERISA specifies the roles and responsibilities of the governing bodies of the plan, including one that requires fiduciaries must act in the best interests of the plan participants.

- The needs of employers are managed; however, employers have a potential conflict of interest between their role as settlor vs. fiduciary.

- Employers can be deterred by what they perceive as excessive rules and regulations.

- Employees and retirees are generally not directly represented on governing boards.

* Employer has fiduciary responsibility for the plan, including selecting plan features and plan investments, maintaining qualified plan status, etc. and making decisions on their part that may negatively impact participants.

* Availability of PBGC protection could create a moral hazard for the employer.

Legend

(+) feature meets principles
(-) feature does not meet principles
(*) feature where there is not enough information to determine impact or actual impact may depend on stakeholder actions

Traditional Defined Benefit Plan Under Current System

Sustainability

D-

Description

- Promotes intergenerational equity.
- Allocates cost properly among stakeholders.
- Withstands market shocks.
- Maintains balance between sustainability and adequacy.

Application of Principles

+ Risks are shared by employer and PBGC.

- Costs are borne solely by employer.

- Funding rules may have historically encouraged poor funding practices by employers by forcing funding when it was least affordable and making it difficult to respond to market shocks.

- Maturing plans present increasing risks to plan sponsors.

- Size of plans is large relative to some plan sponsors.

- Limited flexibility/mechanisms to deal with market shocks (e.g., cannot reduce accrued benefits).

- The trend toward employers closing, freezing, and/or terminating defined-benefit pension plans in recent years demonstrates a lack of sustainability in the current DB system for at least some employers.

Legend

(+) feature meets principles

(-) feature does not meet principles

(*) feature where there is not enough information to determine impact or actual impact may depend on stakeholder actions

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