THE SHIFT FROM DEFINED BENEFIT PLANS TO DEFINED CONTRIBUTION PLANS

by
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The U.S. has undergone a major shift in recent years from defined benefit pension plans to defined contribution plans. The shift has important consequences for most Americans because defined contribution plans, in granting decision-making authority to participants, will often fail to provide adequate retirement income to individuals with median earning capacity. The authors propose a number of legal changes to reduce some of the regulatory handicaps that have attended defined benefit plans and improve the reliability of defined contribution plans as a principal source of retirement income.

The rationale of the national public-private pension system that presently covers—and has consistently covered—just under half of the Americans who work for their living is this: working people from business managers to stock clerks depend on the continuing stream of income they earn each working year to sustain themselves and their dependents; it is not in the interest of enterprises nor socially desirable to require older Americans to sustain themselves in their later years by working until the day they die; and government through Social Security and enterprises through tax-qualified pension arrangements should therefore provide individuals a means, over a working career, of earning a retirement benefit that enables them to approximate their pre-retirement standard of living.

From the 1930s through the mid-1970s, defined benefit (DB) pension plans were the predominant form of private pension arrangement and defined contribution (DC) plans played a distinctly secondary, supplementary role. By the 1990s the situation was reversed; in a little over 20 years, DC plans—and in particular 401(k) plans—had become predominant and that predominance has continued apace.

In the first place, the DB plan sector has declined precipitously. In 1975, DB plans comprised one-third of all plans, enrolled just over two-thirds of all plan participants, accounted for just two-thirds of all pension plan assets and received just under two-thirds of all plan contributions.[1] By 1998, the DB

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[1] *See* William G. Gale, Leslie E. Papke & Jack Vanderhei, *The Shifting Structure of Private Pensions*, *in* THE EVOLVING PENSION SYSTEM: TRENDS, EFFECTS, AND PROPOSALS

sector comprised only one-twelfth of all plans, enrolled a bit under a third of plan participants, had just under half of all plan assets and received under a fifth of all plan contributions.[2] In absolute numbers the sector shrunk from some 103,000 plans in 1975 to 56,000 plans in 1998 and from some 27 million participants to under 23 million participants.[3]

In contrast, by 1998, 401(k) DC plans alone, which had been a minimal factor in the 1970s, comprised two-fifths of all plans, enrolled just under half of all plan participants, had just over a quarter of all plan assets and received just over two-thirds of all plan contributions. In absolute numbers, that year, there were some 300,000 401(k) plans—six times the number of DB plans—with some 37 million participants—1.5 times the number of DB plan participants.[4] In 2004, 63% of workers with pension coverage were enrolled in DC plans only, as compared with 20% of workers in DB plans only.[5] The following year, only 22.7% of retirement assets were in DB plans; the rest were in DC plans and individual retirement accounts (IRAs).[6]

Why has the DB plan sector declined while the DC plan sector has grown? As to the first part of that question, the most cogent explanations that have been offered are: (i) the weight of federal regulation on DB plans, most particularly affecting smaller plans; (ii) the deterioration in the economic situation of a substantial number of the larger enterprises that sponsored DB plans; and (iii) the growing concern of DB plan sponsors that they suffer a competitive disadvantage vis-à-vis firms that do not sponsor active DB plans.

The secular decline in the DB plan sector is a result of the confluence of three developments:

- The headlong flight from the DB sector by two-thirds of the sponsors of smaller plans (those with less than 100 participants) that began in the mid-1980s in apparent reaction to the steep, legislatively-mandated increases in the costs—particularly administrative costs—of maintaining such plans.

- The erosion of the manufacturing industry and the deregulation of the transportation industry, both of which placed many of the prime sponsors of larger DB plans in financial straits that caused them, among other severe cost-cutting measures, to close their plans.

FOR REFORM 51, 55–62 (William G. Gale, John B. Shoven & Mark J. Warshawsky eds., 2005).

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *See* Alicia H. Munnell & Annika Sundén, Ctr. for Retirement Research at Boston Coll., 401(k) Plans are Still Coming Up Short 2 (Mar. 2006), www.bc.edu/centers/crr/issues/ib_43b.pdf.

[6] *See* Alicia H. Munnell, Mauricio Soto, Jerilyn Libby & John Prinzivalli, Ctr. for Retirement Research at Boston Coll., Investment Returns: Defined Benefit vs. 401(k) Plans 2 (Sept. 2006), www.bc.edu/centers/crr/issues/ib_52.pdf.

- The closing or freezing of their DB plans by a growing number of financially sound sponsors of larger long-established plans for the stated purposes of bringing their compensation costs in line with those of their competitors without an active DB plan and of controlling the volatile year-to-year increases in the cost of funding a maturing plan.

In the second place, beginning in the mid-1980s, the formation of new DB plans came to a standstill while the formation of DC plans surged. A structural explanation of this shift is that economic growth in this period has been concentrated in the service and trade parts of the economy in which enterprises had long tended to sponsor DC rather than DB plans. Beyond that, it would appear that the prior experience with DB plans led to a broad management judgment that the comparative enterprise costs and benefits associated with establishing a pension plan favor sponsoring a DC plan rather than a DB plan.

A standard 401(k) plan serves the enterprise's interests by providing its participants—particularly those earning higher compensation and enjoying greater job mobility—a personal, tangible, and portable means of providing for retirement. And, from the sponsor's viewpoint, DC plans are preferred because they are relatively simple and inexpensive to establish and administer; they are partially financed by participant contributions; and sponsors can fund their contributions year by year on a tax-advantaged basis, without being exposed to any of the financial risks associated with providing a defined retirement benefit, or to any appreciable regulatory risk.

From the standpoint of pension plan policy, does this shift from DB to DC plans matter? The experience to date suggests that the answer is "yes." The critical point of difference between these private pension vehicles is this:

- A working person earning an average income who is continuously covered by a standard DB plan will by the operation of the plan accumulate an entitlement—backed by federal law and a federal insurance guarantee—to an adequate level of replacement income at retirement.

- In contrast, such a working person who is continuously covered by a standard 401(k) DC plan is highly unlikely to accumulate sufficient plan account assets to generate an adequate retirement income. The 2001 Federal Reserve Board Survey of Consumer Finances reported that the median balance in DC plans for household heads aged 55–64 was $44,800; in 2004 the median balance for household heads rose to $60,000, which would provide less than $400 a month of annuity income.[7] Offering the "most optimistic view of 401(k) holdings," a 2003 "analysis . . . of a representative sample of 401(k) plans (48,786 of them) and their 14.6 million participants . . . [indicates] that people

[7] Munnell & Sundén, *supra* note 5, at 5.

in their sixties who have been in a 401(k) plan for more than thirty years have balances of about 290 percent of earnings."[8] This translates into a pension balance of $145,000 for a worker earning $50,000 a year, an annual retirement benefit replacing no more than 28% of income, which that "even when combined with Social Security, will not produce adequate [earned income] replacement."[9]

This critical shortfall in the performance of 401(k) and other DC plans is a result of their basic design. These plans were initially introduced to supplement traditional DB plans but have now become the principal private retirement vehicle for most workers. Are they up to the task? Perhaps so in the world of perfect theory. The economic simulations that have been done indicate that, in principle, an average working person who chooses to participate continuously in a standard 401(k) plan, who does so at the maximum contribution level and draws a maximum employer match, who manages his plan account assets prudently and who does not take pre-retirement lump sum distributions, will accumulate sufficient plan assets to generate a retirement replacement income equal to that of a comparable person who had been covered by a standard DB plan. But the survey data indicates that in the real world these pre-conditions to a 401(k) plan outcome equal to that of a DB plan rarely hold:

> Although workers in theory could accumulate substantial pension wealth under 401(k) plans, in practice they do not. Balances—even for long-service employees—are substantially less than those produced by even the most sophisticated simulations. The reason for these low balances appears to be that the entire burden is on employees, and they make mistakes at every step along the way. A quarter of those eligible to participate in a plan fail to do so. Less than 10 percent of those who do participate contribute the maximum. Over half fail to diversify their investments, many overinvest in company stock, and almost none rebalance their portfolios in response to age or market returns. Most important, many take cash when they change employers. And few annuitize at retirement.[10]

In sum, a pension plan design that shifts the decision-making responsibility on plan financial matters—participation, the level of funding, and the handling of the accumulating corpus of assets—from the sponsor (who is in a superior financial decision-making position) to the participants (who are highly unlikely to have the knowledge and expertise necessary to make these

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[8] ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 35 (2004). One of our ERISA colleagues has written to us: "I suggest, however, that the $14,000 annual benefit in your average DC account of $145,000 is too high, as it contemplates a 9.66% payout or withdrawal rate in retirement. I suggest to lawyers here who wish to provide for a surviving spouse of about the same age that they assume a 4–5% payout rate to provide an inflation protected benefit to both spouses. On your $145,000 account, the numbers would be $5,800–$7,250. Faster withdrawals run the risk of running out of assets in the account."

[9] *Id.* at 38.

[10] *Id.* at 173–74.

financial decisions and are if anything even more unlikely to have the time or the capacity to enable them to acquire, and to then continuously apply, the necessary financial knowledge and expertise) is severely flawed. The resulting gap between what DB plans do in fact accomplish and what sophisticated simulations show 401(k) plans might accomplish in providing adequate retirement benefits, follows directly from this shift in financial decision-making authority.

The foregoing suggests two points about the proper regulation of qualified private pension arrangements. First, the secular decline in the DB plan sector is a matter of public policy concern. And while that decline has a number of deep economic and structural causes, the trend has been accentuated by aspects of the DB plan regulatory regime that have proved to be unjustified disincentives to establishing and maintaining such plans. An effort is warranted to adjust these regulations. There is precious little point in insisting on regulations that were put in place to ensure that firms properly perform a certain optional class of activity beneficial to their employees—such as maintaining a DB plan—if the response is that they exercise their option not to perform that activity at all.

While there is not a great deal of obvious leeway for reversing the DB sector's downward trend, there are some possibilities worthy of consideration:

- The law needs to be changed to permit qualified DB plans to provide for retirement benefits in any amount up to or equal to the retiree's pre-retirement base salary (with appropriate indexation for inflation).[11]

[11] For fiscal reasons, the law places a limit on the benefits payable under DB plans. In 1974 the limit was $75,000 or about seven times the wages of the average full-time worker. 26 U.S.C. § 415(b)(1) (1976). In 2005, the limit was $160,000 or under four times the wages of the average full-time worker. 26 U.S.C. § 415(b)(1) (Supp. IV 2001–2005); with the cost of living adjustment in § 415(d), the limit was $170,000 for rretirement ages 62-65. During this period, executive compensation has soared—from 40 times the wages of the average worker to nearly 400 times the wages of the average worker. One result of this divergence between executive and rank-and-file compensation has been the creation of a two-tier retirement system in which executives look to non-qualified plans for the lion's share of their retirement benefit and are increasingly unconcerned with the welfare of the broad-based retirement plan for the rank-and-file workers. *See* Alicia H. Munnell, Francesca Golub-Sass, Mauricio Soto & Francis Vitagliano, An Issue In Brief, Ctr. for Retirement Research at Boston Coll., *Why Are Healthy Employers Freezing Their Pensions?* at 8 (March 2006), *available at* http://www.bc.edu/centers/crr/issues/ib_44.pdf.

Certain deferred compensation plans, known as "top hat" plans, are subject to ERISA's enforcement provisions but exempt from substantive provisions like plan funding and fiduciary duties. A "top hat" plan is one "which is unfunded and is maintained . . . primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." 29 U.S.C. § 1051(2) (2000). The employer does not receive a deduction (hence, the gain to the fisc) and the employee is not taxed until receipt of the deferred amount but any funds set aside to pay these benefits are subject to creditors' claims in the event of the employer's insolvency or bankruptcy. The "rabbi trust," a commonly used mechanism, is "an irrevocable trust for deferred compensation" that cannot be reached by the employer but can be reached by the employer's creditors. *See, e.g.*, *In re* IT Group, Inc., 448 F.3d 661, 665 (3d Cir. 2006). From the firm's standpoint, "using nonqualified retirement benefits is generally not a tax-efficient way to compensate

Where the decision to establish and maintain such plans is at the option of the sponsors, it has proved to be a mistake to create a divergence of interest between the highly compensated executive employee decision-makers and the rank-and-file workforce. Under current incentives, firms have responded by establishing "non-qualified" supplemental executive DB retirement plans and by declining to establish and/or maintain broad-based qualified DB plans.

- The requirements regarding administration imposed on the sponsors of smaller DB plans need to be revamped so as to bring their direct administrative costs—which now run close to twice the administrative costs of smaller DC plans—more closely in line with the costs of the DC plans. The far higher attrition rate for DB plans with fewer than 100 participants than for larger plans indicates that the sponsors of small plans are particularly sensitive to administrative burdens.

- Lastly, the DB plan funding rules should be altered to make it feasible for sponsors, on a tax-advantaged basis, to fund, through regular periodic contributions over the participants' working careers, the plan's full projected liabilities in the benefits expected to be paid to its participants at retirement. It would make particular sense to repeal the percent-of-current-liability limitation on deductions for employer plan contributions.[12] Both sound compensation and sound pension plan principles favor the funding of DB plans through regular tax-advantaged sponsor contributions during each year of a participant's working career of a pro rata share of the benefit expected to be paid to the participant on retirement. Proceeding in this way links the employer's payment of compensation with the employee's reciprocal performance of services to the employer and provides the most certain and prudent means of funding the plan over time. And, sponsors place

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employees." Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 829 (2005).

[12] Congress moved in this direction by liberalizing the current deduction limitation in the Pension Protection Act of 2006. The Joint Committee on Taxation's explanation of the 2006 Act states:

> [F]or taxable years beginning in 2006 and 2007, in the case of contributions to a single-employer defined benefit plan, the maximum deductible amount is not less than the excess (if any) of (1) 150 percent of the plan's current liability [rather than the previous 100 percent], over (2) the value of plan assets.
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> For taxable years beginning after 2007, in the case of contributions to a single-employer defined benefit pension plan, the maximum deductible amount is equal to the greater of: (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a cushion amount for a plan year, over the value of plan assets (as determined under the minimum funding rules); and (2) the minimum required contribution for the plan year.

Joint Comm. on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," at 160 (Aug. 3, 2006). *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 801, 120 Stat. 780, 992–95.

> a value in being able to meet their financial obligations to the pension plan through predictable, relatively equal yearly payments that are part of the participant's yearly compensation. It is thus very much to the point that the current governing rules permit sponsors of DC plans to proceed in this way. That has proved to be a significant factor in the determination to sponsor such plans. Equalizing, as much as possible, the financing rules would be a useful step toward a possible revitalization of a sound DB sector.

Second, the experience to date—made all the more salient because of the increasing prevalence of DC plans as the sole retirement vehicle—demonstrate a wide gap between how such plans perform in theory, in providing the average working person with an adequate retirement benefit, and how they operate in fact. We suggest that to enable these plans to better shoulder their new role, a set of mandated rules along the following lines is warranted: A qualified DC plan must provide for:

- automatic participant enrollment subject to a right to opt out;[13]

- a basic participant contribution rate of 6% subject to a right of readjustment;[14]

- a basic required employer one-to-one match of participant contribution up to a yearly maximum of $2,000;

- a basic investment vehicle of a set of highly diverse stock index funds and a set of highly diverse bond index funds with two-thirds to be invested in the stock funds and one-third in the bond funds subject to a right of redesignation;[15] and

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[13] In view of the shift away from DB plans, and evidence indicating a considerable reluctance on the part of average and lower-income individuals to affirmatively participate in DC plans, even when employers provide a match from their funds, the IRS, in a number of revenue rulings, approved automatic enrollment features in 401(k) and certain other DC plans, along with a 3% employee contribution through payroll deductions, subject to an opportunity to opt-out of the plan. *See* Rev. Rul. 98-30, 1998-1 C.B. 1273; Rev. Rul. 2000-8, 2000-1 C.B. 617. This simple change in default rules increased participation by as much as 35 percentage points and participants have remained in the plans even three to four years after the automatic enrollment. In 2004, 30% of plans with 5,000 or more employees had automatic enrollment provisions. *See* Munnell & Sundén, *supra* note 5, at 6. The Pension Protection Act of 2006 further supports automatic enrollment by freeing 401(k) plans that use this mechanism from the nondiscrimination requirements. Still more needs to be done to institutionalize automatic enrollment.

[14] According to the 2004 Survey of Consumer Finances, only about 11% of all participants contribute the legal maximum to a 401(k) plan. Munnell & Sundén, *supra* note 5, at 3. Extent of contribution is correlated with income; less than 1% of those earning $40–60,000 contribute the maximum compared to 58% of those earning $100,000 or more. *Id.*

[15] DC plans are undiversified. In 2004, 15% of all 401(k) assets were in employer stock; and in large plans with 5000 or more participants, company stock accounted for 34%

- limiting all distributions to workers aged 59.5 years or less only to another 401(k) plan or an IRA.[16]

A few words on each of these proposed mandatory rules follow.

The participation rule builds on the IRS regulation allowing sponsors to provide for automatic enrollment and the experience showing that participants stay enrolled rather than opt out.

The contribution rate rule incorporates the median contribution rate presently being set by participants and, with a cap that focuses on the mandate of meeting the needs of participants earning $50,000 or less, the standard sponsor practice on matches. It does so on the ground that the experience to

of total assets. For the same year, 31.6% of participants held no equity at all and 21% had 80% or more of their plan assets invested in equity. *See* Munnell & Sundén, *supra* note 5, at 4. In 2005, "nearly half of 401(k) participants are nearly fully invested in stocks or hold no stocks at all. That is, nearly 50% of participants are not diversified in their retirement accounts." Munnell et al., *supra* note 6, at 6. That assets held in IRAs substantially underperform assets held in 401(k) and DB plans suggests even less diversification in the IRA sector. *See id*.

The Pension Protection Act of 2006 eases some of the restrictions on provision of advice to participants and beneficiaries in DC plans by creating a new category of prohibited transaction exemption for the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of a DC plan who direct the investment of their accounts under the plan and to beneficiaries of an IRA. *See* Pension Protection Act of 2006 § 601(a)(2)(g), 120 Stat. at 953–58. Such arrangements must provide that fees received by the fiduciary adviser do not depend on which investment option is selected, or must employ a computer model using prescribed objective criteria (and in the case of IRAs, awaiting DOL regulations).. Subject to certain requirements, an employer or plan fiduciary, other than a fiduciary adviser, is treated as not failing to meet ERISA fiduciary requirements by contracting for the provision of advice under an eligible arrangement; the employer or plan fiduciary is still subject to fiduciary responsibility for the prudent selection and periodic review of the fiduciary adviser, but has not duty to monitor the specific advice given by the fiduciary adviser. Plan assets may be used to pay for reasonable expenses in providing investment advice under an eligible arrangement.

[16] Current law uses a variety of taxes, penalties, and defaults to discourage workers from cashing out their pension balances prior to retirement. Funds that are cashed out are taxed as ordinary income and are subject to a 10% penalty for workers up to age 59.5 if the distribution is taken prior to job termination (age 55 if taken as part of a job termination). Munnell & Sundén, *supra* note 5, at 5. Under 1993 legislation, any qualified plan with a cash-out option had to offer recipients the option of rolling over their balances directly to another qualified plan or an IRA, and required employers to withhold 20% of the cash-out of any balance not directly rolled over to such accounts. *Id.* A 2005 Department of Labor regulation changed the default rule for employees leaving their company with a balance of $5,000 or less; hereafter, the employer must roll over any balance between $1,000 and $5,000 into an IRA unless the departing employee elects to receive the cash-out or roll over into a 401(k) with his new employer. *Id.* at 6. Despite this set of incentives, the extent of cashing-out remains significant. In 2004, about 45% of participants in 401(k) plans cashed out when they changed jobs; because most of these individuals were younger workers with relatively small amounts, the value of the cash-outs represented only 18% of total assets. *See id.* at 5.

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date indicates that the rules will be practicable in financial terms both for participants and sponsors and on the economic simulations that project that contributions on this level over a participant's working career are needed if the participant is to accumulate plan account assets sufficient to provide an adequate retirement replacement income.

The investment rule in its turn follows a widely accepted professional inventor's model for the rational, prudent investment of retirement funds, albeit for reasons of practical administration, in a greatly simplified and necessarily inflexible form.

Finally, the experience to date makes it plain that 401(k) plans will not work as retirement vehicles if the participants cash out their accounts from time to time—on a job change or otherwise—prior to retirement. A stringent rule limiting 401(k) or other DC plan distributions for workers aged 59.5 or less to a roll-over to another 401(k) or to an IRA is essential to assuring that 401(k) plans fulfill their assigned tax-supported role as *pension* plans.