Shifting pension plans . . . . . . there are consequences

By Gary W. Findlay

Sunday, May. 28 2006

I'm sure you have noticed a number of articles lately like the one I just read regarding a company that was replacing its traditional defined-benefit pension plan with a defined-contribution plan, such as a 401(k).

The article reported that the company "… will cut retirement costs by about $700 million over the next 10 years by revamping its U.S. pension plans." While these stories are becoming commonplace and are accurately reported, there is another side that is not told.

For example, it would have been equally factual if the report had noted that the company "… took action that, over the next 10 years, will result in reductions in retirement benefits for their future retirees of $700 million plus the amount that $700 million would have earned had it been deposited in a traditional pension plan."

If the pensions that would have been paid would have provided for a subsistence level of income for the masses among the former employees of these companies (which is probably the case), how is the shortfall going to be covered?

If I were a betting person, I'd bet on it being government-sponsored entitlement programs -- in essence, it is likely that this will increase the burden on working taxpayers to fund retiree benefits on a pay-as-you-go basis.

I'm not faulting the corporations -- their behavior seems quite rational. We reward management for increasing net earnings and for increasing prices per share, and the defined-benefit to defined-contribution switches we are seeing can have a significant impact on both.

It just seems incongruous to me that, on the one hand, we are critical of the pay-as-you-go Social Security system because of the increasing burden it will place on taxpayers as the result of shifting demographics and, on the other hand, we applaud and reward corporate behavior that is likely to exacerbate the problem.

Regardless of whether these consequences are intended or unintended, they are predictable.

While I am at it, I probably should mention some of the other probable outcomes of the defined-benefit to defined-contribution switches that make the trend seem attractive to certain special interests.

•A number of people who change employers will take a distribution from their defined-contribution-plan accounts and not roll it over to another retirement savings vehicle. This potentially benefits at least two special-interest groups in the short term. Retailers of consumer products will benefit from the windfalls in discretionary income that will end up in the hands of consumers. Governments also will benefit because tax revenue will

increase as the result of both the premature distribution tax and the ordinary income tax on amounts that would have otherwise remained in a defined-benefit retirement plan.

•Shareholder activism is seen by many poorly performing corporations as a thorn in their side. If the private-sector trend in switching to defined-contribution from defined-benefit plans migrates to the public sector, it will break up the large blocks of stock that are now being voted to effect positive long-term changes in corporate behavior. As a practical matter, the watchdog role of large institutional investors would be eliminated. (My guess is that the Business Roundtable and the Chamber of Commerce would not object to this outcome.)

•High-level corporate managers frequently have a good deal of their net worth tied up in company stock and options on their company stock. It seems reasonable to conclude that those who are nearing retirement might find a pop in their stock price to be quite attractive -- the only thing they have to do to achieve it is "follow the trend" of reducing corporate expenses by promoting a switch to defined contribution.

•Investment-market service providers will benefit because they can get away with charging much higher fees for their services to individually directed defined contribution plans than they can for services to efficiently managed asset pools in defined-benefit plans.

As mentioned earlier, if retirement-plan contribution rates are reduced by virtue of defined-benefit- to defined-contribution-plan conversions, aggregate benefit payments will be reduced even more. Some of the additional probable fallout from a defined-benefit to defined-contribution switch will include:

•Higher rates of employee turnover, resulting in higher training costs and lower productivity.

•Higher poverty rates among retirees (particularly females).

•Increased demands by employees for investment education.

•Potential lawsuits by older employees who believe they were disadvantaged by the switch.

•Bear-market-generated delays in retirement by employees who otherwise would have left the work force (but instead end up being retired on the job).

•Lower rates of retirement income per dollar of retirement contributions.

•Reductions in the national savings rate.

When long-term universal good must contend with short-term special interest, the outcome is commonly predictable and unfortunate, with the short term being the winner.

It seems to me we already are passing on significant amounts of economic trash that future generations will be required to clean up. If we are going to add to it by shifts to defined contribution plans from defined benefit plans, at least I think we have an obligation to let the masses know what is happening.

Gary W. Findlay is executive director of the Missouri State Employees' Retirement System, Jefferson City. *This article originally appeared in Pensions & Investments magazine.* *Copyright Crain Communications Inc.*