

Transitioning your retirement plan from DB to DC

Defined benefit (DB) plans have fallen out of favor. Despite superior DB performance in providing retirement income, employers are turning away from those vehicles, and toward the use of defined contribution (DC) plans as the sole savings/retirement vehicle for their employees. This change in sentiment derives from a number of perceived disadvantages of DB plans:

- High employer costs
- Volatility/unpredictability of cash contributions and accounting expenses
- Administrative burdens due to complexity of applicable law and regulations
- Responsibility for uncertain obligations
- Appeal of an immediate, portable benefit for a mobile workforce

The trend toward DC retirement plans has been underway for 30 years. It started with the origin of the 401k plan and the common observation that the post-war generation was not interested in a promise of a distant benefit at age 65. Ironically, times have changed, and those formerly young employees are marching toward an uncertain retirement. Yet the shift to DC continues unabated.

Overview of the DB to DC conversion process

A systematic approach to the conversion process does not guarantee that everyone will be happy with the outcome. It will, however, produce the best possible solution for the money spent. The key elements in the evaluation are:

- Effects on plan sponsor – The primary effect will be the cost of the new program (including the cost of the DB plan after it is frozen), but the new program may affect retention and hiring, if your organization has had a philosophy of long service in exchange for retirement benefits.
- Effects on participants – Inevitably, some will win and some will lose. DB and DC plans deliver benefits differently. The DB plan channels most of the contributions to those who will eventually retire from your organization, while the DC spreads the money, with more going to younger employees and those who have short careers.
- Effects on the DC plan – You may have a 401(k) or a 403(b) plan, to which a basic employer contribution, and possibly a match, will now be added. As noted below, you may decide to provide additional

contributions to a grandfathered group who are particularly vulnerable to the transition. And while you are maintaining two programs, non-discrimination testing may be needed.

- What happens to the DB plan – Unless you decide to continue the DB plan indefinitely, it will be frozen and will need to be maintained and funded until the time at which it is terminated, and all benefit obligations satisfied through the purchase of annuities or payment of lump sums. Until then, you will need to administer the plan and decide on an investment strategy.
- What is your budget? – The main reason that DB to DC studies fail to reach a successful conclusion is a failure to define an acceptable budget number. The budget has long-term and short-term aspects. In most cases the DB plan must be continued for some time, because participants are accruing benefits, or because the plan is not well enough funded to be terminated. So the plan sponsor will normally be supporting DB and DC plans for some time period, with commensurately higher costs. Ultimately, the DB plan will terminate and the only cost will be the DC plan. The target budget will guide the design of the replacement DC plan and quantify how far the sponsor can go in providing additional benefits to participants who are adversely affected by the transition.

Identifying candidate replacement DC plans

The budget target will help identify potential replacement DC plans. For example, you could choose to evaluate all of the following:

- Level percentage of pay for all participants (equal to the target budget)
- A plan that provides greater benefits for those who are older or longer serving, or a combination based on age and service
- An employer contribution plus a matching contribution

It is generally advisable to limit the number of candidate plans and then refine them after the first round of analysis.

Deciding how and when to modify a DB plan

Eventually the DB plan will be phased out. The question is when? There are several basic approaches:

- Close plan to new participants, but continue benefit accruals for existing participants (“soft freeze”)
- Close plan to new participants, and freeze benefit accruals for existing participants, either immediately, or at a future date (“hard freeze”)

The advantage of a delayed freeze is that it softens the blow for those close to retirement. For example, with a five-year delayed freeze, participants currently 60 and older will reach age 65 under the current program. Those aged 55 to 60 will see some partial reductions in their projected benefits.

Deciding how and when to modify a DB plan

In order to understand the impact of a plan change on the organization, it is essential to perform multi-year projections of the cash contributions and accounting expense under the continuing plan scenario and each of the alternatives, taking into account the cost of the DB plan and contributions to the DC plan. The projections will allow a comparison of the new program to the target budget and provide a guide for fine-tuning of the DC alternatives.

Identifying the winners and losers

The next step is to compare the effect of the currently projected DB plan benefits to the expected benefits under alternative scenarios:

- Assuming that the current DB plan continues without change
- Assuming that DB benefit accruals are stopped or curtailed at some point and the switch is made to a DC plan

The analysis will compare projected benefits under the DB plan to the combination of the frozen DB plan benefit (i.e., the amount accrued under the DB at the time of the freeze) and the benefit derived from the contributions to the new DC plan.

Generally benefits will be compared at the DB plan’s normal retirement age (usually 65), and the accumulations under the DC plan will be converted to an equivalent annuity. The projected benefits will be divided to projected salary so that any shortfalls will be expressed as percentages of final pay at retirement.



Consider the following example:

The current DB plan provides a benefit of 1.5% of final five-year compensation times years of service up to 35. The replacement DC plan would provide an employer contribution of 3% and a matching contribution of 3%. Consider the effects on three different participants, with the following characteristics:

Employee	A	B	C
Current age	35	45	55
Current service	5	10	25
Current compensation	45,000	75,000	125,000

What happens to each employee if the DB plan is frozen and replaced with the DC plan? The following table shows benefits projected to a retirement age of 65 as a percentage of the final earnings before retirement.

Employee	A	B	C
Projected DB benefit	48.6%	41.7%	48.6%
Frozen DB benefit	2.1%	6.3%	23.5%
Projected DC benefit	20.4%	12.3%	5.6%
Sum of frozen DB and DC benefit	22.5%	18.6%	29.1%
Gain (loss) from new program	(26.1%)	(23.1%)	(19.1%)

In this example, clearly everyone loses at age 65. The older participants experience smaller losses, but there is less time to adjust plans to take the shortfall into account. To close the gap would take a DC plan with a much larger contribution, or one in which the contributions are also increased for those with greater age and longer service.

Each projection assumes that:

- Salary increases are 4% per year
- Assets in the DC plan earn 6% per year
- Account balances are converted to annuities using a conversion rate of 5%



Caveats regarding projections

Usually the projections are performed for age 65, because the purpose is to measure the changes in retirement benefits. There is no reason that the two alternatives cannot be compared at other ages, for example at 50, 55 and 60. All else being equal, comparisons at younger ages will reduce the loss under the new DC plan or even demonstrate the superiority of the DC plan. An equal cost DC plan will usually provide lower benefits at retirement, but the flip side is that it will provide better benefits at younger ages.

The importance of assumptions

Benefit projections depend on several important assumptions:

- What will be the assumed annual salary increase?
- What is the assumed rate of return on invested DC balances?
- What will be the assumed interest rate for converting DC balances to equivalent annuities for comparison to DB plan benefits?

Choosing assumptions for the projections may appear to be a technical detail, but you should understand what effect changes in the assumptions will have on the comparisons:

- Increasing the assumed annual salary increase assumption for the typical final average pay DB plan will make the DB plan look better.
- Increasing the rate of return on invested DC balances will make the DC plan look better.
- Increasing the assumed interest rate for converting DC balances will make the DC plan look better.

The effect of changes in the assumption may be modest for those closer to age 65, but for younger employees, the projections may diverge substantially, due to the power of compounding.

Fine tuning the design

Odds are that the results of the first round of analysis will not reveal desired results. The overall costs may be too high, or the losses for certain groups may not be acceptable. You may wish to have a simpler DC plan design, and therefore may rule out age or service-based formulas.



Changes in the overall cost of a DC plan can easily be accomplished by adjusting the contribution rates. Reducing the impact on participants can be more challenging, but can be achieved by:

- Delaying the freeze date of the plan
- Making additional lump sum contributions
- Increasing the annual contributions for a period of time

It is usually impossible to make older participants whole at an acceptable cost, which is a key difficulty in bringing a DB to DC study to a successful conclusion. The real purpose of the study is to identify trade-offs between cost and equity, and to show decision makers that no perfect solution exists, but only tolerable ones.

What happens to the DB plan?

In today's economic climate, most DB plans are underfunded and cannot be terminated. Furthermore, the additional contributions needed to make the plan sufficient for termination are likely to be too high. Consequently, the DB plan will need to be maintained for some time, at least until it is completely frozen and the underfunding has been reduced or eliminated. The investments of the plan should be evaluated to determine if any changes should be made to reduce the volatility of the underfunding, such as a change to liability driven investing.

Plan termination

Once a plan is frozen, it is almost certain that it will be terminated. In order to terminate a plan, you must settle all benefit obligations to participants, either by purchasing annuities from a qualified insurance company or by offering lump sum payments which are equivalent in value to the vested annuity. Starting in the 2012 plan years, the cost of lump sum payments will be roughly equal to the actuarial liability calculated for IRS purposes; so a plan must be fully funded on the IRS basis, for a shot at termination. You cannot force participants to take lump sums, and some participants may wish to retain the annuity. Annuities are likely to be more costly than lump sums. To the degree that participants prefer annuities, or if you decide not to offer lump sums, the cost of plan termination may be significantly higher than the IRS funding liabilities.

It takes about 12 to 18 months to terminate a plan, and the Pension Benefit Guaranty Corporation requires certain procedures be followed. In addition, when a plan has been in existence for a while, random issues are likely to surface on termination. For example, some participants cannot be located or others may come forward who had not previously been known.



Summary

For good or ill, organizations are moving away from their traditional DB plans and adopting DC plans as their sole retirement/savings program. It is worthwhile to undertake a thorough analysis of the effects of such a transition on the finances of the organization and its participants. Aside from quantifying the impact, the primary purpose of a study is to educate decision makers about the tradeoffs in making a transition. They should be comfortable in making a compromise that all parties can live with.

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