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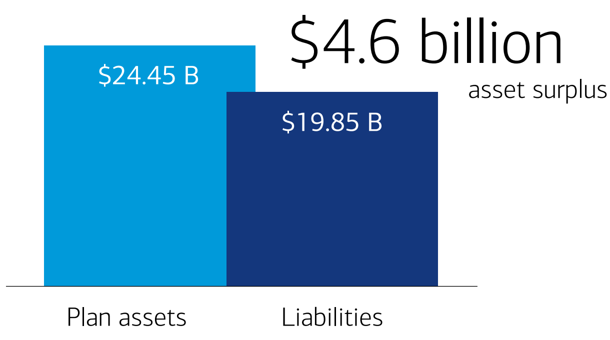
Rethinking the future for defined benefit plans

According to conventional thinking, the future for defined benefit (DB) plans is that of gradual decline as plan sponsors reject the associated costs and risks. Under this thinking, sponsors are expected to continue favoring defined contribution (DC) plans as the premier employee retirement plan benefit. However, IBM's surprising decision to reopen its cash balance plan in 2023 might suggest a different direction for the retirement industry.

There are several valid reasons behind the trend of DB plan decline in America, but recent events and developments could challenge that. In light of these changes, plan sponsors may wish to explore the ways that DB plans can be used effectively.

IBM's 2023 plan reopening

Like many other pension plan sponsors, IBM saw its plan's funded status improve in recent years as rising interest rates shrank the plan liability. As of year-end 2023, the plan assets of $24.45 billion far exceeded the liability determined to be roughly $19.85 billion.[1] The excess of about $4.6 billion represents a significant asset surplus for the plan. Pension surpluses can be tricky to utilize, since removing any assets from a pension trust is generally not permitted. Assets can be reverted to a plan sponsor as part of a plan termination, but heavy excise taxes would then apply.



IBM found a better solution. Effective January 1, 2024, it reopened its pension plan under a cash balance design — which looks and feels similar to a DC plan for the participants. The new "Retirement Benefit Account" will effectively replace the company's 5% nonelective contribution made to the DC plan,[2] providing immediate cash savings to the company. Furthermore, if IBM invests the pension surplus well, it could continue to provide this retirement benefit for many years without a significant future cash outlay. This could function as a competitive advantage for IBM, both in terms of retaining talent and providing value to shareholders.

IBM's action has sparked conversations among plan sponsors that are reevaluating their retirement benefits strategy. DB plans and associated surpluses have the potential to be tremendously utilized by plan sponsors. Before exploring how DB surpluses can be used, it's important to understand the factors that led to DB plans closing, freezing and terminating in recent decades.

The old paradigm

During the dot-com bubble, DB plans experienced significant asset and funded status volatility. The global financial crisis began a period of historically low interest rates, making pension plans more expensive than they had ever been.[3] The Pension Protection Act went into effect in 2009, increasing contribution requirements for most plans, and Congress began using Pension Benefit Guaranty Corporation (PBGC) premium increases as a phantom revenue raiser. Worst of all, these events came consecutively, which resulted in "pension fatigue" for much of the industry.

Consultants, service providers and members of the pension media focused on potential solutions to pension fatigue, with plan termination often proposed as the best option for many DB plans. This resulted in the subsequent development of exotic strategies that focused on how to terminate a DB plan without necessarily exploring whether plan termination was in fact the most appropriate solution. The support for the argument that plan termination was broadly appropriate generally focused on a few main areas.

Reasons we believe defined benefit termination was viewed as the ultimate end state

Termination potentially:

- Eliminates future plan expenses
- Avoids risk and volatility
- Evades a trapped surplus

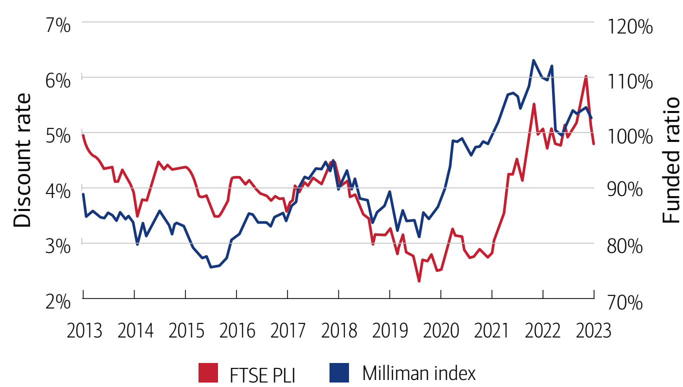
Eliminates future plan expenses. There are various administrative costs associated with maintaining a DB plan. Actuarial, accounting and legal fees are common. Plus, PBGC premiums have increased significantly. Terminating a plan eliminates all future plan-related expenses but typically requires paying an additional premium to an insurance company to annuitize benefits. As plan-related administrative costs increased, the net present value of those maintenance expenses was sometimes estimated to be higher than the termination premium, implying that termination was financially advantageous.

Avoids risk and volatility. Plan sponsors saw their plan's funded statuses worsen significantly due to extreme market shocks — most notably, the "perfect storm" combination of equities and interest rates falling together at the start of the global financial crisis in early 2009. The continued decrease in interest rates through 2020 additionally frustrated many plan sponsors. Plan termination was viewed as a solution to market volatility.

Evades a trapped surplus. If a terminating plan reverts surplus assets back to the plan sponsor, the sponsor is heavily taxed. This taxation doesn't incentivize companies to maintain a fully funded plan, as any upside is limited. Plan sponsors are also heavily penalized if their DB plan is considerably underfunded. As a result, plan sponsors are pressured to perform a continuous tightrope act — consistently attempting to keep funded status high, but not too high. By terminating the plan, this could be avoided.

While these arguments for plan termination were based on truths, presenting termination as the only viable option created an environment where the relative merits of DB plans were often ignored.

Discount rates and funded ratios[4, 5]



This chart shows the volatility of pension plan funded ratios and interest rates over the last 10 years. The correlation is notable, with rising interest rates in 2022 contributing to funded ratio improvement.

Sources: Yield Book by FTSE Russell and U.S. Department of the Treasury; Milliman, a third-party consulting firm not affiliated with Bank of America Corporation.

Reasons to consider using defined benefit plans in the future

Broadly, plan sponsors have begun favoring defined contribution over defined benefit plans to avoid the risks associated with maintaining a DB plan. DC plans aren't magical in that they eliminate these risks. Rather, the risks previously borne by companies with DB plans are transferred to employees and retirees who, under a DC plan, are expected to both save and invest their own assets. Many participants invest inappropriately, fail to save enough, or both, setting themselves up with inadequate assets for retirement. For retirees, turning their asset pool into a reliable stream of lifetime income is a considerable challenge. Arguably, employers may have the resources to best deal with these challenges. But how might a company get comfortable with the costs and risks associated with maintaining a DB plan (again)?

Effective tools for managing funded status volatility. With the headwinds mentioned previously in mind, many DB plan investment strategies have begun incorporating liability-driven investing (LDI) and de-risking glidepaths. DB plans face asymmetric risk, where they're punished disproportionately more for a deterioration in funded status than they're rewarded for a gain. To manage this risk, many plans implement LDI to hedge interest rate risk and stabilize funded status over time. This method allocates a percentage of plan assets to a fixed income portfolio designed to have strong correlation with the variable liability. Plans have also begun using de-risking glidepaths, where an increasing percentage of the portfolio is allocated to LDI as the funded status increases.

Cost-effective retirement income. DB plans include insurance-like risk pooling features. These are particularly effective for managing longevity risk — the risk that retirees outlive their assets. A DB plan can provide guaranteed income for life, without devising personalized asset drawdown strategies based on a participant's hypothetical life expectancy. Effectively, retirees who die earlier (and thus don't require as much retirement income) help subsidize the benefits for retirees who live longer than expected. In addition to benefiting plan participants, addressing longevity risk might also benefit employers aiming to attract an employee base that cites interest in retirement income.[6]

Professionally managed investments. DB plans can benefit from professional investment management at a reasonable cost — given negotiating leverage stemming from large plan sizes. Further, DB plans have the flexibility to pursue a wider array of investment strategies. These include private and illiquid alternative investments, which may allow for either higher returns or a greater level of diversification. A DB plan can benefit from strategies, investments and expertise that would otherwise be unavailable to plan participants at an individual account level.

Higher current discount rates. Since 2020, pension plan discount rates have risen nearly three percentage points. Pension service costs (the cost of providing new benefits) are very sensitive to interest rates, since new benefits will often come due decades into the future. With higher discount rates, those costs have fallen dramatically. For example, a plan's service cost could have been halved due to the recent rise in interest rates. It's possible that rates won't remain at their elevated levels, but savvy plan sponsors, such as IBM, that have a diversified DB and DC retirement system, can attempt to take advantage of the current interest rate environment. If interest rates fall significantly in the future, they can shift away from the DB plan, or vice versa. Plus, an incorporation of LDI, mentioned above, should also help these sponsors more confidently weather future rate uncertainties.

Trapped surpluses not necessarily a concern. The Employee Retirement Income Security Act of 1974 (ERISA) has long allowed for terminating DB plans to reduce or avoid excise taxes — provided the surplus is used in certain ways. This is explored in more detail below. As DB plan termination became the "ideal" end state for many plan sponsors, the potential uses for surplus assets were often overlooked. The recent SECURE Act 2.0 legislation brings renewed attention to these options by enhancing some viable methods for effectively utilizing a pension surplus without paying excise taxes. As a result, the argument that the risk of a trapped surplus is reason to terminate a DB plan now carries less weight.

Turning a trapped surplus into a tapped surplus

According to previous thinking, one of the best solutions for a trapped surplus was to avoid it entirely. In many cases, plan sponsors have adopted de-risking glidepath strategies specifically designed to avoid pension surpluses. Removing the entire pension surplus from the pension trust is only possible through a plan termination. When a plan sponsor takes a full asset reversion, a 50% excise tax applies in addition to corporate income taxes. However, should sponsors find themselves in a surplus asset scenario, there are other options available. The preferred surplus utilization tactic will depend on the plan sponsor's objectives and benefits strategy.

Some potential uses for pension surplus include:

- Using a DC structure in the form of discretionary contributions
- Funding retiree medical benefits via 401(h) transfers
- Reopening plans under a variety of available design options
- Doing something new or unexpected

Using a DC structure in the form of discretionary contributions. A common use of a pension surplus is reallocating the funds to employees in the form of employer discretionary DC contributions. This can generate significant cash savings in the near term, potentially without significant changes to a company's benefit package. This approach is not without limitations,[7] and a plan sponsor should carefully review pertinent details before potentially moving forward.

Funding retiree medical benefits via 401(h) transfers. As an immediate result of SECURE 2.0 legislation, it's now considerably easier to use surplus pension assets to fund retiree medical or life insurance benefits through an amendment to Section 420 of the Internal Revenue Code. Essentially, plan sponsors can now use a small portion of surplus pension assets each year to fund a 401(h) account for the provision of those benefits. This was allowed previously, but now sponsors with smaller pension surpluses have access to this option — with the threshold dropped to a funded ratio of 110%. Originally set to expire in 2025, Section 420 was extended through 2032, which provides more regulatory certainty. There are various restrictions on this strategy, and plan sponsors will need to consult with ERISA counsel to determine whether this may be appropriate for them.

Reopening plans under a variety of available design options. One of the most straightforward ways to use a pension surplus is to provide an ongoing pension benefit. This is what IBM chose to do. Depending on plan sponsor goals, certain variations may be more or less enticing, but DB benefits are traditionally delivered in one of the following forms:

- **Traditional pension benefits** that provide guaranteed retirement income can be a great retention tool and are a differentiator as employers compete for talent. Under this design, employers completely shift saving, investment and longevity risk from employee to employer — arguably addressing many current retirement readiness challenges voiced by plan participants.[8]
- **Cash balance pension benefits** can be structured to closely resemble a DC benefit. More traditional designs typically provide interest credits at a conservative rate with no downside risk for participants. Under this design, it's also possible to align investment performance with participant accounts, either for the pension trust as a whole or for an asset allocation selected by the participant.
- **Reopening grandfathered plans to all employees** is an option for plans providing benefit accruals to a subset of participants but closed to new entrants. In addition to using the pension surplus, this option allows for a more homogenous company benefit offering, which may be appealing to some plan sponsors.

Doing something new or unexpected. IBM has shown that DB and DC plans can exist side by side. Plan sponsors could expand on this approach by embracing the flexibility of DB plans. Plan sponsors could use DB plans as a supplemental benefit to ensure their retirees have some lifetime retirement income to address longevity risk. Or, to help minimize the wage gaps that exist by race, gender and ethnicity, DB plans could be designed as a "base benefit" that only considers years of service. Plan sponsors could create custom-tailored benefits programs for their employees using a combination of DB and DC.

Potential implications of a defined benefit revival

Under the old paradigm, pension plans were widely viewed as an aging product in the last phase of their relevance — with the broad consensus being that DC plans are the preferred retirement products of the future. However, IBM's recent decision to reopen its DB plan could challenge this stereotype. The current interest rate environment, fears regarding future Social Security retirement impact,[9] and a general lack of retirement readiness[10] across the U.S. may be the conditions necessary to revamp the DB industry.

While employers might be hesitant to expose themselves to some inherent DB risks, the upside could prove difficult to ignore.

The chief concerns associated with DB plans under the old paradigm are not without standing, but the foundation forming those concerns has morphed recently. The evolution of investment strategies designed to make pension-funded status more predictable could make DB plans a more manageable balance sheet item. Higher discount rates make defined benefits relatively less expensive to offer, and, for sage plan sponsors who invest well, there are now better options for leveraging any accumulated surpluses.

DC plans, if used to their full potential, have proven to be a powerful tool. But these plans aren't without their own shortcomings. DC plans can be used to accumulate assets to great effect, but spreading these assets over an unpredictable lifespan can be challenging. This might be a key driver of participant interest in "guaranteed income" annuity options embedded in retirement accounts.[11] DC plans also require that participants rationally save and invest, which has historically been difficult to promote. The existence of retirement readiness differences across demographic segments, which remain prevalent despite social advances,[12] is also troubling.

Solutions to these problems within DC plans are evolving, but they come with costs. Implementing guaranteed income within DC plans solves the asset drawdown problem, but with additional insurance costs. Participants lacking investing confidence or expertise could have access to portfolio advice programs but likely with additional fees. Saving is often promoted via educational campaigns, employer matches and auto-enrollment, but some participants still don't save enough.

DB plans naturally address these issues without elaborate workarounds. Especially for employees who live paycheck to paycheck, have minimal investing expertise, or live under other constraining circumstances, a DC plan may place them at a disadvantage relative to their retirement readiness under the DB model.[13]

Some plan sponsors might begin to weigh the risks of managing a pension against the cost of a plethora of DC add-on options. From an employer perspective, attracting and retaining top talent is a current priority. This may persist well into the future as the work environment remains variable and employee behavior continually shifts.[14] In the evolving employee benefits universe, providing a DB plan to employees could be a differentiating and cost-effective talent acquisition and retention solution.

[1] *Let's Create: IBM 2023 Annual Report*, International Business Machines Corporation, 2024.

[2] Nonelective contributions are made by an employer on behalf of employees without employee discretion.

[3] This is largely due to a variable liability (calculated by taking a present value of project future benefits with a low discount rate), significantly outpacing asset performance.

[4] The FTSE Pension Liability Index is a public index and widely accepted benchmark for calculating the liability of a pension plan; it is based on high-quality corporate bond rates as of the date shown.

[5] The Milliman 100 Pension Funding Index projects the funded status of pension plans included in an annual study of the 100 largest pension plans sponsored by U.S. public companies.

[6] *The transforming workplace: Insights to help companies evolve with the needs of today's workforce*, 2023 Workplace Benefits Report, Bank of America Corporation, 2023.

[7] All surplus assets must be used within seven years. Further, surplus assets can only be applied to nonelective contributions, not to matching contributions. A company could suspend its match with a discretionary contribution, presumably with limited impact on plan participants.

[8] See note 6, above.

[9] See note 6, above.

[10] See note 6, above.

[11] Alicia H. Munnell, Wenliang Hou and Geoffrey T. Sanzenbacher, *Trends in Retirement Security by Race/Ethnicity*, Number 18–21, Center for Retirement Research at Boston College, November 2018.

[12] See note 6, above.

[13] *Understanding the American worker*, Bank of America Corporation, October 2023.

[14] See note 6, above.
