Testimony of Richard Hudson, FSA, FCA, MAAA, EA
Principal Consulting Actuary, Cheiron
before the U.S. Senate Committee on Health, Education, Labor and Pensions,
on the topic of "Pension Modernization for the 21st Century"

Sept. 20, 2012

Question: *Defined benefit pension plans have provided a secure retirement for millions of middle class Americans, but it is clear that the traditional pension system is in decline and that existing defined benefit pension models may not be well-suited for some of our 21st century workforces. What should our pension system look like to meet the challenges of the global economy and the need to provide retirement security for working Americans?*

Response: The Defined Benefit plan is the best way to provide retirement security for Americans. The current ideas need to be revamped though. Companies should not be taking significant investment risk with assets in the pension plan and certainly should not be taking any risk with money needed for retiree liabilities.

Insurance companies have been able to provide annuities for many years with little trouble, the reason is they invest in a way to control cash flow risk and count on risk pooling to reduce the overall level of mortality risk they are subjected to.

Defined Contribution plans are favored by employers as they shift all the risk to the plan participants. What is not clearly understood is that Defined Contribution plans introduce an additional level of risk for the participants. This additional risk is mortality or longevity risk – participants as individuals can only avoid this risk by pooling via an insurance contract which is a hard choice not many take and can be very expensive. In a Defined Benefit plan the mortality risk is pooled amongst all the employees of the plan. This risk pooling helps reduce the level of risk.

In addition, when employers shift to a DC plan, the older workers lose out significantly since they don't have time to accrue large enough accounts to replace the lost accruals from the Defined Benefit plan. Also, in general, participants do not fully understand how to invest and as a result many take the safest option available which reduces the long term investment income in their accounts. Another problem with 401(k) and similar plans is that the investment vehicles offered have higher investment fees and investment bookkeeping fees that would be found in large DB plans.

The current Defined Benefit plan system can survive if expectations are modified and responsible parties are made aware of the risks and understand how to mitigate underlying risks.

We have been successful in assisting some clients to create new defined benefit plans or continue in the defined benefit arena with a better understanding of long term expectations.

Question: *What would make it easier and attractive for businesses – especially small businesses – to provide their employees with a traditional pension benefit? Would reducing the employers' risk and plan complexity help?*

Response: The employers' risk and plan complexity can be dealt with through proper plan design. The main issues we face in assisting our clients are:

1. Will the new designs we are developing for our clients receive a favorable determination letter from the IRS. It would help for newly created pension plans to receive priority in the IRS review process over current plans who are re-applying for a determination letter. Once we get a couple of these "hybrid" plan designs approved, employers will be more confident in the design concept and not have to worry about whether or not contributions made to these plans will be deductible.

2. The PBGC premiums are reaching levels that make sponsors take pause in thinking about retirement plans. If a plan sponsor does the right thing and designs a pension plan with policies in place to mitigate risk, the likelihood of needing PBGC insurance is very low. But, they do not receive a break from the PBGC premiums. In actuality, if they freeze their current plan and establish a new plan with lower risk and lower benefit accruals, the amount of their retirement benefits decline but the PBGC premiums double. The focus should be on variable rate premiums where the risk is and possibly lower the flat rate premiums.

3. Some multi-employer plans are suffering under the weight of liability associated with past withdrawn or bankrupt employers. This is causing a tremendous amount of strain on these plans as they need to reduce benefit levels or even freeze future accruals to pay off the liability for these "orphan" liabilities.

Question: *What do employees need from a pension plan to ensure that they will have a secure retirement?*

Response: The participants need to know they will not outlive their assets. Defined Benefit plans provide a level income for life so retirees can plan their finances. They know what they will have so they know what they can spend. This makes them more comfortable and allows them the freedom to spend money without being anxious about running out of income. The efficiency of an annuity is not well understood and the benefit of an income for a long life is overshadowed by the cost of not leaving a residual balance of retirement savings to one's heirs. To illustrate the efficiency of an annuity as an example, if we plan to live on $2,000 per month and take a 10% risk of out-living our savings we would need $340,000 to retire at 65 if we were confident of earning 6% per year through our investment skill. Contrast that with the cost of an annuity for $2,000 per month - $320,000 (assuming 3% investment earnings) which has no risk of being outlived.

Participants also need the plan to have stable funding during the accrual years. When the cost of funding the plan gets too high employers switch to DC plans. Defined Benefit plans have smaller accruals in early years and larger accruals in later years. Defined Contribution plans

have relatively larger accruals in early years (because of compounding interest) and smaller accruals in later years. If an employee works for an employer for many years earning the smaller accruals, they need to be rewarded with the higher accruals that come at the end of their career. When an employer switches to a Defined Contribution plan, they are hurt again by now getting smaller relative accruals in the DC plan which significantly hurts their overall retirement benefit. Therefore, the plans need to be established for long term sustainability in mind.

Defined Contribution plans provide participants with a lump sum of money which is likely not enough to retire on. There are several reasons for this. Participants do not save enough nor do they start to save early enough. They also do not have the investment knowledge to properly invest their accounts. Individuals in these plans feel like they must continue to work longer, save more, and spend less to achieve their retirement goals. Since the limits on how much an individual and employer can contribute to a Defined Contribution plan are significantly less than Defined Benefit plans, the ultimate retirement benefits will be less. Also, employers tend to switch to DC plans to save money, so even if deductions were not a problem it is likely that the contribution amounts would still be insufficient.

Some plans are looking at providing lifetime income benefits in DC plans through an annuity purchase but this is very expensive for participants if the annuity is purchased through an insurer. A Defined Benefit plan handles annuities more efficiently.