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From the Editor

A Brief History of Pensions

The past 40 years saw private-sector defined benefit (DB) pension plans gradually replaced by 401(k) and other defined contribution (DC) plans. Yet, most folks would be better off with a lifetime pension and—benefit dollar for benefit dollar—a DB plan is the more cost-effective of the two. A brief history of the DB-to-DC transition may be helpful for politicians, academics, and humans considering the much-needed overhaul of the current mess of the U.S. retirement and savings system.

In the 1980s, most companies offered a DB plan and the big issue was *overfunding*. High-interest rates (which minimize benefit liabilities), a strong stock market, and steady contributions combined to create surplus DB assets. Before the '80s, companies used their relatively modest pension surpluses to take funding "holidays"—saving cash and improving profits while expecting the excess to gradually wear away.

Instead, pension funding continued to improve with favorable financial markets and, by 1980, DB overfunding grew sufficiently large to begin burning a hole in corporate pockets. The first big company to act was the A&P supermarket chain (once the largest retailer in the world). In 1981, A&P terminated its DB plan and captured $200 million in surplus, using the proceeds to finance a companywide restructuring. (It eventually failed, and A&P is no more.)

With the pension gates opened, two questions arose: who owns the excess, and what should be done with it? Employee and retiree advocates argued that the surplus belonged to participants and should be used to protect benefits in the lean years or to increase benefits, say through a cost-of-living adjustment. Businesses argued that since they were on the hook for any DB underfunding, they were also entitled to any surplus.

After several years of ERISA litigation, it became settled law that participants had no rights to the overfunding if their DB document said that employers owned the "actuarial surplus" on plan termination. DB plan termination is a relatively straightforward, if somewhat lengthy, process: all employees become 100-percent vested, and the plan buys an insurance company annuity covering each participant's benefit. Sometimes participants are offered the option of a cash payment in lieu of an annuity.

Typically, after a termination, the DB plan was replaced by a DC plan, usually a new-fangled 401(k). However, some employers wanted to capture the DB funding surplus *and* continue providing employees the security of a pension. What to do? Creative advisors came up with the "spin-off termination," splitting the plan into two plans: the first for current employees with enough money to cover all benefits and the second for retirees and former employees and all of the remaining assets (including the surplus). The second plan was terminated and the excess assets were paid to the employer. Spin-off terminations were controversial until the Internal Revenue Service ruled that these transactions, with proper safeguards, didn't run afoul of the Tax Code. Given that the excess belonged to the employers, spin-off terminations were a win–win, allowing employees to keep their pensions and employers getting the surplus.

Even companies that wanted to leave their overfunded DB plans untouched became nervous that a corporate raider might use the surplus as "free money" to fund a takeover—hence, the popularity of "pension parachutes" that automatically triggered benefit increases to soak up any DB plan surplus upon a hostile takeover.

An unsavory element of the excess asset recapture emerged when a few companies selected the cheapest annuity they could find to satisfy the plan's benefit obligations, even if the insurance company selling the annuity was financially weak or downright sketchy. Some of these insurers did indeed go broke. Fortunately, litigation, state insurance guaranty funds, and Department of Labor (DOL) rulings combined to protect participants and punish abusers.

Ironically, while companies were capturing pension surpluses, the 1980s also saw employees advocating for DC plans over DBs. Huh? At the time, this seemed logical. Inflation was high, quickly eroding the value of a fixed lifetime pension, and large numbers of employees began job-hopping. A DB plan works best when someone spends his or her entire career at the same company, while DCs are portable. Perhaps the biggest enticement of DCs was a booming stock market; employees wanted a piece of the action. A DC plan where each employee had his or her own account and could benefit from high investment returns seemed the perfect ticket to wealth and security.

Once most employers that wanted to had captured their DB overfunding, Congress—Democrats and Republicans alike—jumped in to "help." Starting in 1986, a series of "reforms" imposed draconian tax penalties on recaptured pension surpluses, punished employers with underfunded plans, and increased Pension Benefit Guaranty Corporation insurance premiums. Several times, Congress also curtailed the amount of benefits that high-paid executives could earn through various limits on benefits and pensionable compensation. The message to employers was clear: you'll be punished for DB plan underfunding but won't be able to capture any overfunding and must limit the pensions of senior executives—the very folks deciding the fate of the DB plan. At the same time, interest rates began declining, making DB plans more expensive and overfunding a relic. DB plans became a lose–lose proposition for management. Companies responded by, first, closing their DB plans to new employees (soft freeze) and then eliminating all future benefits of grandfathered employees (hard freeze). More recently, companies are "de-risking" by buying annuities to assume some of their pension obligations, thereby transferring responsibility to insurance companies (that, after all, are in the business of paying lifetime benefits). All told, few companies are continuing their DB plans, and no sizable employer has started a new DB plan in decades.

And workers? Today, inflation is quiescent; stock markets are volatile; and most folks have realized that savings, investing, and retirement planning are complicated and time-consuming. It turns out that DB plans can be an efficient and effective way to provide retirement income. Alas, the regulatory and economic winds are blowing in the opposite direction, making private-sector DB plans too dangerous for most employers.

Pension history teaches that a sound retirement system requires long-term thinking and cautions Washington about imposing well-intentioned but ineffective new restrictions. The pension of yesteryear will not return, but we can and should pluck what worked from DB plans and use it to develop a solid system that provides lifetime income for a reasonable cost.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

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