Defined Benefit Plans with Risk Sharing Can Survive

January 1, 2012

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The shift away from traditional defined benefit plans in the private sector is unlikely to reverse. Not surprisingly private sector employers do not relish bearing the entire risk associated with their employees' preparation for retirement. The employer bears the investment risk as it invests accumulated contributions over the employee's working life; the employer bears the risk that interest rates will be very low – and therefore the price of liabilities very high; and the employer bears the risk that the retiree will live longer than projected, thereby significantly increasing the cost of lifelong benefits.

But individuals need pension arrangements where they do not bear the full brunt of market swings and their accumulations are paid out as annuities rather than lump sums. The question is whether hybrid pension arrangements could offer enough risk sharing to make them attractive to both the employer and the employee.

The Netherlands is one place to look for a model. The Dutch system has three pillars. The first offers a basic flat-rate pension to all retirees that is financed on a pay-as-you-go basis. The second pillar provides retirees with earnings-related income and covers 90 percent of the labor force. The third pillar is personal savings.

The Netherlands' second pillar mainly consists of defined benefit plans. In the post-war period, these plans were structured as final pay plans, similar to traditional defined benefit plans in the United States. In the wake of the 2000 perfect storm, however, when falling stock returns and falling interest rates hit pension funds, most of the defined benefit plans moved from basing benefits on final earnings to indexed career average earnings.

In an average-wage plan, individuals accrue pension rights annually based on the salary earned in each year (rather than final pay). Earnings are usually re-indexed each year to take account of inflation or wage growth. The accrual rate is 2 percent or even higher. After retirement, benefits are generally indexed to the increase in prices or wages.

An important feature of the Dutch average-wage plan is that the level of indexation in any given year depends on the financial position of the pension fund. Thus, if the fund is below its solvency target, the indexation rate for that year will be less than the growth rate of the relevant index. For example, say that wages grow by 4 percent. The indexation factor might be reduced to three-quarters of the wage growth rate. In this case, retirees would see their benefits rise by 3 percent. And active workers would see their wages adjusted by 3 percent for the purposes of calculating their earned pension rights for that year. On the other hand, when pension plans are well funded, this process can work in reverse to catch up for prior years in which workers received less than full indexation.

Thus, the current typical average-wage scheme in The Netherlands is a hybrid plan, midway between a traditional defined benefit plan, with flexible contributions and well-defined indexed pensions, and a defined contribution plan, with uncertain benefits and well-defined contributions. The hybrid achieves the goals of partially shielding the participant from the swings of the market and paying benefits as an annuity.

The Dutch model seems preferable to the hybrids adopted by some of the Fortune 100 companies where the employer defines the benefit, similar to a traditional defined benefit plan, but the final benefit is defined as a lump-sum rather than as an annuity.

For the United States, the path to a Dutch-type hybrid is difficult to envision. If most employers still had traditional defined benefit plans, such a shift might be feasible. But employers are unlikely to move from 401(k) plans, where they bear no risk, to a hybrid, where they once again bear at least some of the risk.