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Light at the End of the Tunnel for Defined Benefit Plans?

Could There Really Be a Solution All Sides Agree On?

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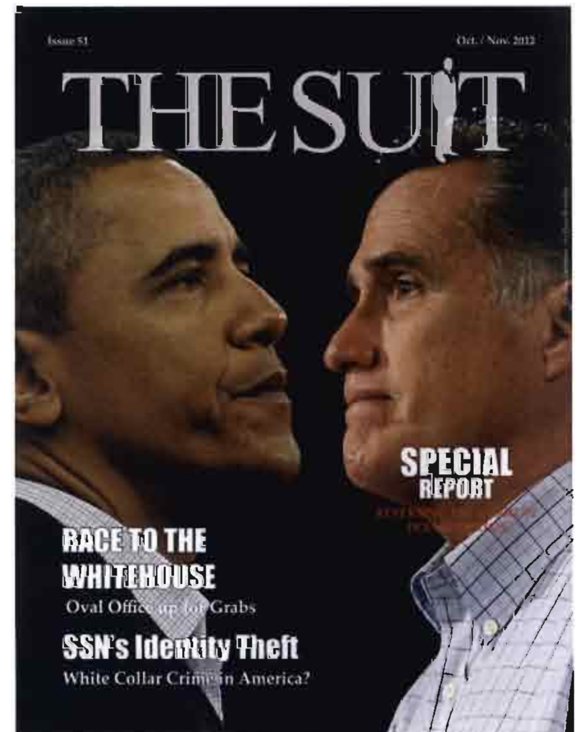

BY WENDY CONNICK

LIGHT AT THE END OF THE TUNNEL FOR DEFINED BENEFIT PLANS?

Could There Really Be a Solution All Sides Agree On?

Few issues appear more divisive and societally destructive than those caused by the pervasive underfunding of defined benefit retirement plans, especially those of state and local governments. Seldom does a news cycle pass without numerous new stories of the inability of some city, town, or state, incapable of meeting its financial obligations, seeking to reduce its pension commitments to its employees and the inevitable pushback of those employees who are unwilling to relinquish benefits that they feel they have legitimately bargained for and earned. And, between these two diametrically opposed positions there appears to be no common ground - only "winners" and "losers" in an apparent "all or nothing" game in which no side really "wins."

But, what if there was something that could be done - something that could help to close the pension underfunding gap - something both sides could agree on? Could CSSC's innovative and newly patented investment manager selection and performance monitoring processes be the missing answer?

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Once upon a time, defined benefit pension plans were not just a benefit of "public service" employment by state and local governments, but were also an expected part of corporate life. Employees worked at the same company for decades and retired knowing that their pensions would allow them to live comfortably and without financial worries. But from the employer's point of view, defined benefit plans have a serious drawback - they place all the investment risk on the employer.

The terms of these pension plans require the sponsoring employers to pay retired employees the agreed-upon benefits, whether or not the pension's funds are adequate to meet those needs. If the pension's investments do poorly and if the contributions into the plan aren't enough, the employer is forced to make up the difference.

That's why defined benefit plans have been almost entirely replaced in corporate America by defined contribution plans, in which the employer and/or employee contributes a certain sum but the employer is not required to provide a "defined" retirement benefit at the end. Defined contribution plans, which most commonly appear in the form of the familiar 401(k) plan, place all the investment risk on the employee - if he or she hasn't accumulated enough money in the account to live on during retirement, that's their problem.

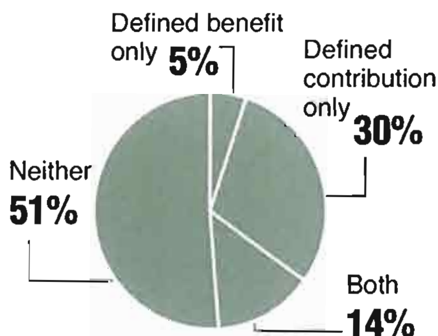
"The introduction of 401(k)-type plans has, over time, displaced defined benefit plans for many companies," said Marc Hopkins, a spokesperson for the Pension benefit Guarantee Corporation (PBGC). The PBGC is a government entity that steps in to protect pension benefits if the employer can no longer meet its obligations. It is funded by insurance premiums paid by companies that sponsor defined benefit pension plans. The PBGC's most recent annual report says that there are about 27,000 private-sector pension funds today that have 25 or more enrolled workers. That's down from the all-time high of over 114,000 pension plans in 1985. In 2011 alone, PBGC took over benefits responsibilities for more than 4,300 failed pension plans. And, according to Hopkins, since 1975 over 170,000 plans have ended in a standard termination - meaning that those companies chose to discontinue their defined benefit pension plans.

"There are what I'll call a 'perfect storm' of issues which have led to [pension plan failures]," said David Hildebrandt, who is a senior partner at the law firm of Kirton & McConkie and an internationally recognized expert in pension and welfare benefit plans. "The most common one is probably the aging population of participants. If participants live longer, the liability for a defined benefit plan increases. The second is the current financial and capital markets' environment. And the third one is that the actuarial assumptions for assumed investment earnings in these plans are sometimes in excess of 7%, which is proving to be unrealistic in today's market."

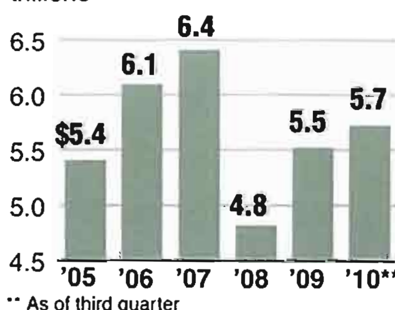
Joe Saburn, an attorney who was formerly in-house ERISA counsel for AT&T and is now a partner at Ogletree Deakins, agrees. He states that, "to a large degree, the underfunding problem springs from faulty assumptions about fund investments' likely rates of return." And, he explained that the stock market simply hasn't behaved as predicted. "Since 2008 but even before that, in 2002 and in the late 90s, we've had some significant investment downturns. And the assumptions that

Pensions and 401 (k)-type plans for all workers

More U.S. workers now have 401(k)-type plans (defined contribution) than have pensions (defined benefit) plans



Like public pensions, private plans lost assets due to the decline in value of equities in which they were invested; total financial assets in all private funds, in trillions



** As of third quarter

Average payout from 401(k) accounts, if worker retired today at 65 years, given an average life expectancy after retirement of 17.6 years

Workers who have contributed without interruption for at least 10 years

Average account balance	**$183,100**
Annual payout	**$10,400**

All participants

Average account balance	**$71,500**
Annual payout	**$4,063**

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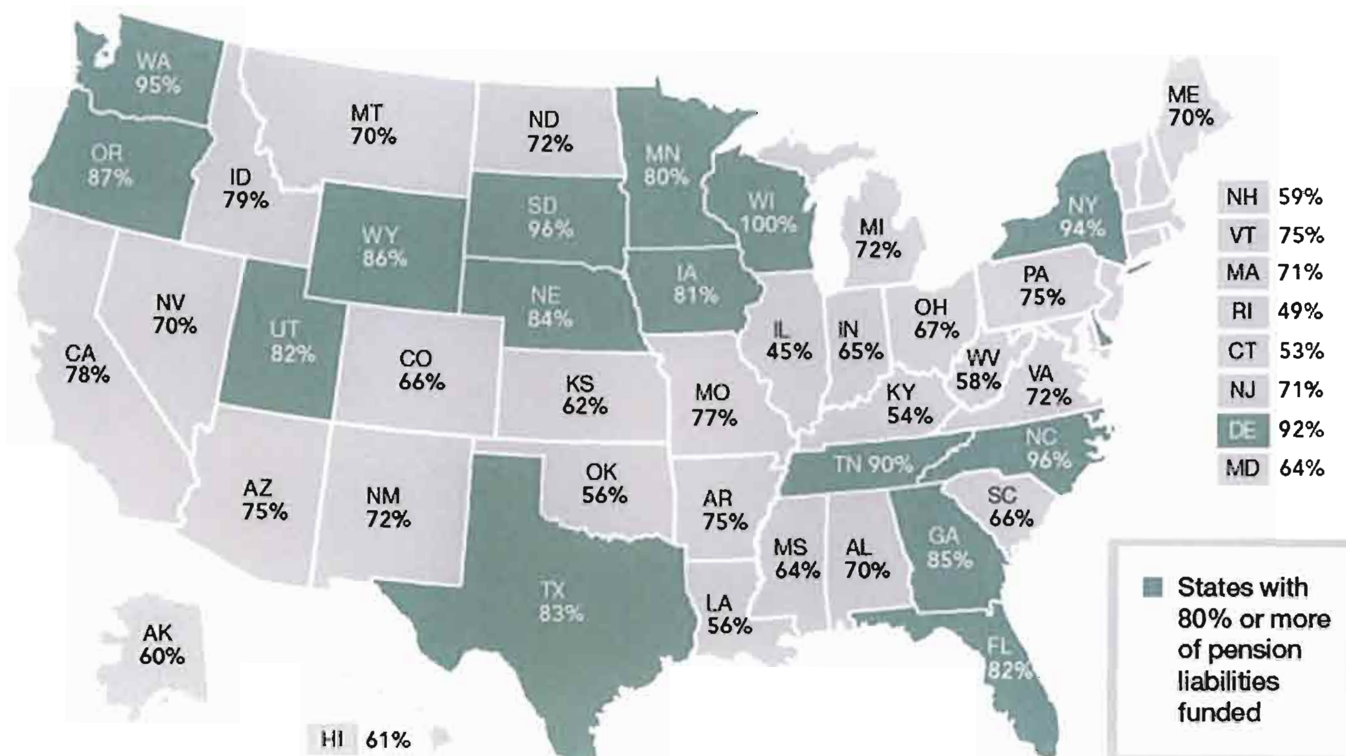
Source: EBRI, National Association of State Retirement Administrators, Public Fund Survey, Center for Retirement Research at Boston College, Fidelity Investments
Graphic: Pat Carr

The Widening Gap Update: Public Sector Pensions



the actuaries have used, even though absolutely legal, have not been matched by the actual real market returns that the plans need in order to maintain their full funding obligations," he said. "In reality, the investments have over that time produced somewhere between 3 to 5%. So what that means is that funding deficits have been accumulating, for the majority of plans, over the last 10 to 15 years."

And he points out that, "worse yet, many pension fund trustees, who are responsible for choosing the fund's investment strategy, aren't necessarily experts on picking investment managers. They usually rely on third party vendors or investment consultants. But the trustees ultimately have the responsibility of fulfilling the funding requirements for the plans. So some of these trustees, seeing that there's a growing funding deficit, have been chasing riskier and riskier investments in order to try to maximize the returns. And, as markets have continued to fluctuate, those risky investments have only made their underfunding problems worse."

The failure of many, if not most plans, to produce the needed, targeted level of investment returns (often referred to as their actuarially assumed rate of investment return) may well be one of the most troublesome of the causes of the current pension crisis. Two major investment market "crashes" in the last 10 years have caused chronic but manageable levels of pension underfunding to now become dangerously and unmanageably large. Many public pensions are underfunded to the tune of millions or even billions of dollars. And these pension funding problems are starting to spread out in a ripple effect, touching more than just the plans' enrolled employees.

At least twelve local governments have sought relief from the crushing burden of their retirement and benefit obligations through Chapter 9 bankruptcy filings, and an increasing number of states have and are taking action to reduce their benefit burdens. In Wisconsin, for instance, the state's pension crisis led to demonstrations at the state capital and a recall attempt against the Governor and various state representatives. And, this appears to be just the beginning, with the trend away from defined benefit plans toward defined contribution plans now beginning to take hold in the public plan sector as well.

This was predicted by Thomas Mackell, Jr., former Chairman

> *"You'll find that you'll get police who are not willing to run down a dark alley after a perpetrator or a firefighter who is not willing to run into a burning building because he now doesn't have enough healthcare coverage if, God forbid, he gets injured"*
>
> *- Thomas Mackell*

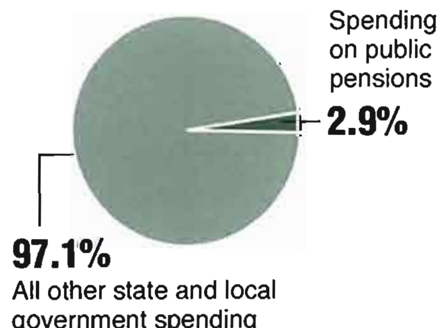
of the Federal Reserve Bank of Richmond, Virginia, in his book, "When The Good Pensions Go Away." Mackell's book, which was published in April of 2008, predicted with startling accuracy the effect that mortgage-backed securities and other complex investment products would have on the stock market, as well as the devastating effect that the stock market crash that those risky investments provoked has had on defined benefit plans.

Mackell believes that in a transition away from defined benefit plans to defined contribution plans a key motivator to draw highly qualified employees into dangerous professions such as police work and fire fighting will be lost. "Just think for a moment that, without a decent pension plan to give them, you may find that you now get police who are not willing to run down a dark alley after a perpetrator or a firefighter who is not willing to run into a burning building, because each now doesn't have enough coverage if, God forbid, he gets injured, and is forced to retire." There is also a second societal problem that Mackell predicts will come from the transition to defined contributions plans - an increased number of retirees who won't have enough money in their 401(k) accounts to support themselves during retirement. "The average American doesn't know the difference between a stock and a bond and we're now going to ask them to plan their long term asset allocation? I think it's criminal," he said. "About 50% of the baby boomers are ill prepared financially to retire. That does not portend for a very positive environment from a social, political or economic perspective. And quite frankly, I have visions of elderly people living under bridges, along the highways and byways and railways of America."

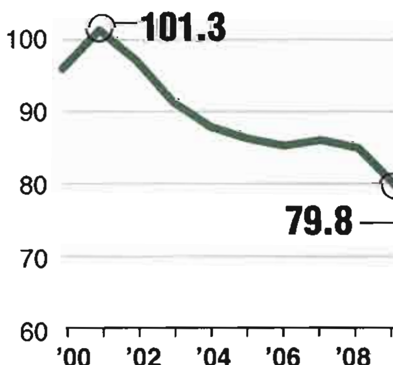
According to Tom Mackell, the move away from defined benefit plans is not simply a national trend, it's fast becoming a national crisis. Seldom does a news cycle pass without numerous new stories of the inability of some city, town, or state, incapable of meeting its financial obligations, seek-

State and local pensions

While public pension costs have risen due to loss of assets, taxpayer spending on pensions is small, contrary to the claims of critics of public employee pensions



Some public pensions are underfunded, mainly due to a decrease in value of equities in which the funds invested; funding level, 2000-2009



Status of retirement funds in the largest statewide systems, as of October 2010

Total assets	$2.1 trillion
Total benefits paid	$160 billion
Number of beneficiaries	7.5 million
Average pension for newly retired worker*	$19,000
Number of years funds would last, on average, if they were frozen today	13.1

*Many do not receive Social Security

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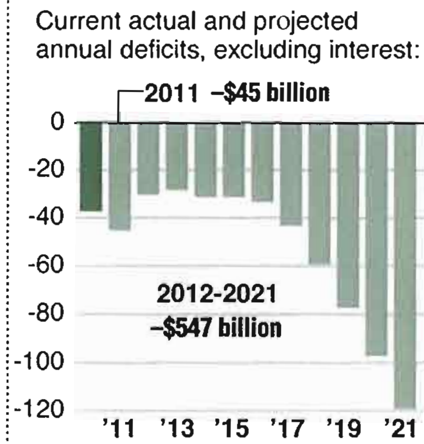
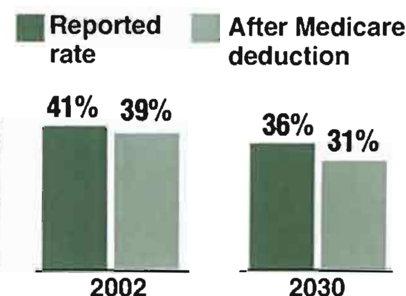
Source: EBRI, National Association of State Retirement Administrators, Public Fund Survey, Center for Retirement Research at Boston College, Fidelity Investments
Graphic: Pat Carr

Social Security

New congressional analysis shows Social Security running deficits every year until its trust fund is depleted in about 2037. Some analysts say an improvement in the economy will cause Social Security to run surpluses again, but the trust fund would still begin drawing down around 2024. Unless changes are made, Social Security will not be guaranteed for future generations of workers





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Source: EBRI, National Association of State Retirement Administrators, Public Fund Survey, Center for Retirement Research at Boston College, Fidelity Investments
Graphic: Pat Carr

ing to reduce its pension commitments to its employees and the inevitable pushback of those employees who are unwilling to relinquish benefits that they feel that they have legitimately bargained for and earned. And, between these two diametrically opposed positions there appears to be no common ground - only "winners" and "losers" in an apparent "all or nothing" game in which no side really "wins."

But, what if there was something that could be done - something that could help to close the pension underfunding gap - something both sides could agree on? This question was posed in a recent conversation with Eric Smith, President of CSSC Investment Advisory Services, Inc., an attorney with a Harvard economics background that heads a team focused on developing innovative techniques and strategies to improve investment decision-making and investment results. He pointed out that, "In the completely polarized public debate swirling around the crisis, there is actually one possible solution that is never mentioned in any of the news stories, not on TV, on radio, or in print, and that is improving investment performance - a solution that both plan sponsors and organized labor can agree upon."

Why then is this solution never mentioned? Smith believes it is because the investment results experienced by most defined benefit plans have so consistently fallen below those plans' benchmark indices (i.e., what the plans could have achieved had they simply invested their portfolios in index funds) - in other words, that "inferior investment performance has become so commonplace that it is considered to be part of the problem, and not a possible solution." According to Smith, if viewed in that way there are only a few possible solutions left, all of which lie at the core of the current divisive debate.

He described the situation in this way: "The position of state and local governments is now often this: 'we don't have the money. We just can't afford it. The fact is that we are underfunded and we now have to 'book' the amount of the underfunding on our financials under GASB [Government Accounting Standards Board] Rules. That's lowering our credit ratings, which means that it costs us more to borrow money. It's a budget buster. We simply can't do it anymore.' On the other side are the public employee unions whose position is often: 'we've negotiated and worked for these benefits, and we won't give them up.' These two positions are diametrically opposed, with no apparent common ground."

In June 2012, GASB passed two new reporting standards that will require public pensions to change the way they disclose their liabilities and expenses. While the goal was to improve the level of transparency with which pension fund boards conduct their operations, public pension funds are now facing the daunting task of redesigning their reporting process. Saburn has worked recently with several municipal pension funds to set up GASB compliant reporting plans. "Prior to the GASB regulations, municipalities paid for post-retirement benefits on a pay as you go basis," he said. "GASB is in the process of requiring those municipalities to recalculate and recalibrate their long term pension liabilities, so in the next six months to a year we're going to see a lot of municipalities booking obligations that they historically have not. And actually, that's going to be a big eye

> *If you could improve the investment results of defined benefit plans, the funding gaps would gradually close over time"*
>
> *- Eric S. Smith*

opener for America." And, this will likely make the distance separating the positions of plan sponsors and public sector employees grow even larger.

These two positions have focused the public debate on two possible remedies: raising contributions or lowering benefits. Requiring employees to contribute more would help to minimize the underfunding shortfall, and if that isn't enough, state and local entities could raise taxes and put that revenue into the pension fund. The other option is for plan sponsors to cut the pension's benefits, which would reduce their funding requirements to the point where they could hopefully erase much of their underfunding gap. Both options are feasible ways to fix the underfunding crisis, but would cause significant pain to the side affected. Cutting benefits would obviously adversely impact covered employees. And, raising taxes would essentially penalize every taxpayer in each affected area for that pension's underfunding and poor investment performance. The obvious third option - the option chosen by most of corporate America of terminating such plans and moving to defined contribution plans - is seen by Tom Mackell and most public employees as much worse than either of the first two.

To help resolve this divisive debate, Smith believes a new focus needs to be placed on improving the investment results in such plans. "The choice is not just between raising taxes and/or cutting benefits, or doing away with such plans entirely. If you could improve the investment results of defined benefit plans, the funding gaps would gradually close over time," he said. "If plan investments produced better investment results, contributions wouldn't have to be as much, which means there'd be less stress on the plan, and less need to cut benefits. As an example, the City of New York has five defined benefit pension plans, the aggregate value of which is approximately $120 billion. If the performance of those five plans could, in aggregate, be improved by only one percent that would be $1.2 billion dollars the city wouldn't have to contribute. Why wouldn't plan sponsors and employees alike all prefer and embrace such a result?"

But, if poor investment performance is so commonplace, is there really a way that investment performance can be improved? Smith believes that there is, but believes that it will require changing the way investment managers (those who manage investment assets within plan portfolios) are selected and their performance is monitored. As Smith points out, "the fact that inferior investment performance is so commonplace is the best proof that the current methods of manager selection and performance monitoring simply do not work well - and one cannot continue doing the same things in the same way and reasonably expect a different result." And, after many years of work studying this problem, on May 4th, 2010 he and his team at CSSC secured a U.S. Patent for a new manager selection and performance monitoring process that he and a growing group of legal experts believe could not only increase the chances of improving investment performance but could also become the next fiduciary standard for how managers are selected and their ongoing performance is monitored by pension plans of all types.

What makes this new focus on manager selection and performance monitoring appear promising is the fact that the majority of investment managers employed by pension plans typically underperform their performance benchmarks, meaning that they often produce lesser returns than the plan would have received if it had simply invested in equivalent index funds.

Because of this, a number of plans are adopting "passive" investment strategies, in which the majority (if not all) of the plans' assets are invested in index funds. But, even though raising investment performance to the level of market (i.e., index fund) averages could make a potentially significant difference in the underfunding problem of many plans, even that may no longer be enough.

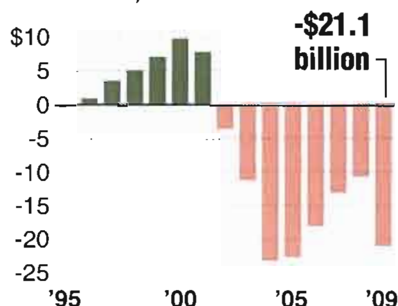
Smith points out that "because current rates of return are so low, "passive" index fund-based investing may no longer be capable of producing sufficient returns to allow plans to meet their current actuarial estimates - the estimates of investment returns necessary to keep contribution levels from substantially rising (a rise many experts believe is inevitable)." He believes that some "active management" may well be necessary, but that the inability of most plans to pick good active managers has been one of the most significant problems facing the plans - chronic underperformance by a plan's investment managers simply

Who insures private pensions?

The Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures corporate pensions against losses, is facing a large deficit that taxpayers may end up covering.

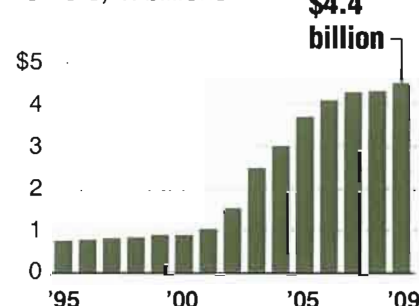
PBGC's shortfall

The plan has been running a deficit since 2002, in billions



Annual payouts

Amount paid out to retirees, and workers, in billions



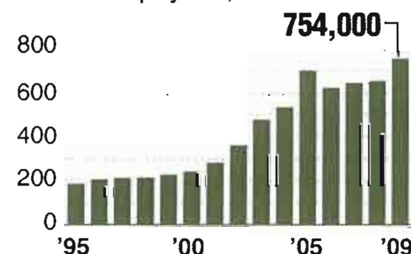
PBGC at a glance

- **Created** by Congress in 1974 to insure defined benefit pension plans (traditional plans)
- **Covers** more than 44 million U.S. workers, retirees
- **Funded** by premiums paid by firms sponsoring pension plans, revenue from fund's investments

Source: Pension Benefit Guaranty Corporation

Who got paid

Number of payees, in thousands



makes matters worse, perpetuating and exacerbating the downward spiral.

"When Eric and his team at CSSC were doing their research on a broad range of public and Taft-Hartley plans here in the U.S., what they found is that 80+% of the time, the plans' portfolios did not meet their blended performance benchmarks," Hildebrandt said. "That clearly proves that while some of these plans' managers might be good, the majority were simply subpar." This is what the advocates of "passive," Index fund based investing have apparently been saying all along - that the vast majority of active managers can't beat their benchmark indexes over time. However, Hildebrandt also points out that "if 80-90% of active investment managers underperform their benchmark indexes, making the "odds" of selecting superior or even "good" managers much less than a coin toss, then the corollary must also be true - 10-20% must outperform equivalent index funds. The problem has been that, historically, there appears to have been no consistent way to successfully identify them." Smith hopes to be able to change that.

This is what Hildebrandt, who has studied CSSC's patented process, finds especially interesting about it. "If CSSC has a methodology with the right criteria and a patented technology-based process with which to comparatively evaluate the qualified, available choices, then there's no subjectivity in that, there's only objectivity with respect to the identification of the top performing managers - the managers who have proven best over time at producing the desired investment result. You can then do due diligence on those top scoring managers and pick the one(s) you want, knowing that all of them, over time, have demonstrated a proven ability to outperform the herd. In an objective and fully transparent way, it offers plan trustees a practical means by which they can identify those investment managers that have proven 'best' at producing the particular investment effect, the blend of investment performance and risk metrics, the plan is seeking from each portfolio asset class over time."

More specifically, Eric Smith points out that CSSC's patented process of manager selection and ongoing performance monitoring, accomplishes a number of tasks, any one of which would logically seem to enhance a plan's chances of improving its investment performance. Smith said that "it provides plan trustees with the means by which they can substantially broaden their access to qualified manager choices."

He believes this to be "one of the keys to improving investment performance since, to the extent that smaller universes, such as the 'proprietary databases' and 'approved lists,' are used the less chance plans have of finding the 'best' for them. If that manager is not among the choices available, the plan trustees simply cannot choose them." Smith also pointed out that "it enables plan trustees to cut through all of the marketing hype and spin produced by the thousands of private account managers and mutual fund companies, i.e. the marketing and advertising related "noise" that can make such choices so difficult."

Even more than simply the "noise" in the financial marketplace, recent scandals in that marketplace highlight the risks associated with undisclosed and difficult to discover conflicts of interest and sometimes outright corruption. As Smith stated, "CSSC's patented process filters

out all of the behind the scenes deals, relationships, and other conflicts of interest that can too often negatively affect the investment advisory process and lead to the selection of inferior managers. Moreover, it makes effective use of the massive amounts of performance, risk, and other data concerning the universe of available managers, to help trustees comparatively evaluate them, objectively and fairly, in a manner specific to the needs and goals of each individual plan."

David Hildebrandt emphasizes the importance of these particular elements of CSSC's process in this way. "Now, how pervasive are such undisclosed conflicts, deals, and relationships? I don't know. Maybe they are pervasive. There have certainly been a significant number of reported scandals, in one of which a national investment consulting firm was forced by the SEC to send letters to nearly 100 institutional clients telling them that the firm had been taking undisclosed compensation from the managers it had been recommending to them. So, in addition to the best tools available for comparatively evaluating and selecting investment managers, we need to implement the most robust set of internal controls and procedures possible, more than the law requires, in order to insure that there are no abuses."

Because CSSC's advisory process is so objective and transparent, using it would appear to make it far more difficult for trustees to select inferior or subpar managers - or be steered toward them. The results it provides are ranked in order of composite performance, with the highest performing managers at the top of the list. Smith illustrated this point by pointing out that, "In the last 24 months, I believe 9 people went to prison for steering the money of one large state pension plan to particular money managers in return for commercial and political bribes. If they had used a process like this, perhaps nobody could have gone to prison. How could anyone realistically think they could walk into a boardroom and say, 'I know that the number 1 and 2 ranked managers look pretty good, but number 176 looks pretty sweet to me.'"

Moreover, by objectifying and optimizing the manager selection and performance monitoring process in this way, Hildebrandt, Saburn, and other prominent ERISA and employee benefits attorneys believe CSSC's process provides plan trustees with an enhanced degree of defendability in their manager selection and performance monitoring decision making. And, since lawsuits have begun to be filed against plan trustees over their investment related decisions, and since trustees may well be personally liable to the full extent of their personal net worth for such decisions, ensuring the defendability of the investment-related decisions of plan trustees will become an increasingly important area of concern - especially for those serving as trustees. Speaking on this issue, Jeff Mamorsky, who heads Greenberg Traurig's Employee benefits practice and is one of the nation's foremost employee benefits/ERISA attorneys (and one of the drafters of ERISA), addresses the defendability issue in this way: "Process = Prudence. In other words, in order to demonstrate fiduciary 'prudence' one needs to employ a process, but not just any process. Arguably, employing a 'process' that consistently does not produce the intended result may not ultimately demonstrate fiduciary prudence at all, especially if another demonstrably better process is available."

David Hildebrandt goes one step further, in stating that the "prudent person" standard has actually become a barrier to beneficial innovation in the pension investment world - that "just because everyone is doing the same things, in largely the same ways, should not necessarily provide 'cover' for continuing to employ ineffective methodologies." In speaking earlier this year to plan sponsors and providers in Europe, an area which is facing a similar and possibly more urgent crisis, he urged the European community to adopt a "best practices" standard, and introduced Eric Smith to explain what he believes that to be. In-

By the numbers: Pension reform a hot topic across the U.S.

3%: current amount of all state and local government spending used for eployee pension benefits

13%: projected amount needed to be spent in the future

Illinois Response:

Accept a change in COLA adjustments or lose state-sponsored health insurnace

Ohio Response:

teachers increase retirement contributions by 4%, 2.25% for police and fire

Louisiana Response:

New 401(k) plan for new hires, fixed return rates for state and universlly retiree pension investments

terestingly, Hildebrandt's position is that "while 'best practices' is always 'prudent,' what may currently meet the 'prudent person' standard here may not always be 'best practices.'" And, Hildebrandt believes that plan trustees should always be seeking to employ "best practices" in the discharge of their fiduciary duties.

CSSC's patented investment advisory process may well prove to be the way to provide that level of improvement. "It's a much better process by which to select active money managers and to monitor their ongoing performance - of determining whether to retain or fire and replace them," Smith said. "And we, at CSSC, are so confident of the results that will be produced by using this new methodology that, to the best of our knowledge, we're the only investment consulting firm willing to offer qualified institutional clients pure performance-based pricing. If that portion of a plan's investment portfolio entrusted to our process doesn't beat the plan's blended benchmark indexes - in other words, what the plan could have achieved by investing solely in index funds - for an entire year, CSSC would not get paid." That's certainly putting their money where their mouth is.

But, why CSSC? Why wasn't this new manager selection and performance monitoring process, unique enough to receive a U.S. Patent, developed by one of the large, national investment consulting firms? Part of the answer seems to lie in the fact that Smith is not your typical investment consultant, never having worked in or been trained by that industry. Smith is an attorney with over 22 years of private practice experience in estate planning, corporate transactions, and ERISA, not a veteran of the financial services arena. He first perceived a need for this unique investment manager selection process because his legal clients continually complained about their inability to see behind the financial advisory curtain. "The traditional investment advisory process seemed completely opaque, leaving our clients with no way to independently evaluate what was being recommended," he said. "The way it's commonly done now, a consultant will often show up at a plan's board meeting with a list of three or four names, though there may perhaps be over 600 qualified investment managers from among which the client could theoretically choose. And, at that usually time constrained meeting, the consultant will quite often say, 'we've done our due diligence, and here are the ones we recommend.' But, how they arrived at those three or four names is not entirely clear to the board or to me as their legal advisor. I always believed that there must be a better way and, after a great amount of time and effort, we believe we found that better way."

> ***"Times of crisis are often times in which beneficial changes can and do occur - simply because they must"***
>
> ***- Eric S. Smith***

"Times of crisis are often times in which beneficial changes can and do occur - simply because they must," Smith said. "It often takes a severe crisis for those impacted to be jolted into the realization that they cannot continue to do things as they have always been done, because it simply no longer works." He then pointed out that in every "crisis" there is not only "danger," but also "opportunity." The current pension crisis certainly spells increasing danger for state and local governments facing budget busting obligations and increased borrowing costs, for plan participants facing the reduction or loss of benefits upon which they were counting for their retirement security, and even plan trustees who now face becoming increasingly easy targets of those seeking someone to blame. But, as he also points out, it is a time of "opportunity" - a time of enhanced possibilities for beneficial change. If a new and improved way of doing things is indeed now possible, it couldn't come at a more important time. It will be interesting to see if plan trustees will put this new alternative to the test, and to see if this truly proves to be the solution which so many have been seeking.

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