Conceptualizing the Defined Benefit Pension Promise

Implications From a Survey of Expert Opinion

by Gordon L. Clark and Ashby H. B. Monk

The long-term transition from defined benefit (DB) to defined contribution (DC) occupational pensions has been the subject of academic and industry research. Even so, there remains considerable debate about the causes and consequences of this transformation. This article explores these contentious issues through a unique survey of over 1,260 U.S. experts in the field of pension financing and provision. The results suggest that apparent disagreements among experts over the current predicament and future of DB pensions in the private sector represent disagreement about the very nature of the pension promise. Those who hold to a strong version of the pension promise hold to, in fact, a quite specific relational model of modern capitalism.

INTRODUCTION

Employer-sponsored pension benefits have been important in many Anglo-American countries for supplementing modest state social security (compared to Europe; see De DeKen et al. 2006). In fact, one of the success stories of the second half of the 20th century was the diffusion of such benefits to many working men and women in unionized industrial and public sectors (Sass 2006). However, the long-term transition from defined benefit (DB) to defined contribution (DC) pensions, coupled with the retreat by some employers from offering retirement income benefits altogether, has prompted concern over the future of employer-sponsored pension and retirement savings schemes (Munnell 2006). In the aftermath of the late 1990s stock market bubble and crash, it has become commonplace to talk of a “pensions crisis” threatening the viability of existing schemes and institutions (Clark and Monk 2007a, 2007b).

The trajectory of declining U.S. private DB pension coverage rates has been the subject of extensive academic research. For example, the increasing burden of regulation, the impact of changing accounting rules on plan sponsors and the increasing significance of market competition for plan sponsors have all been linked to the retreat from DB to a more general process of cost containment in the context of globalization (see, generally, Mitchell and Smetters 2003; Clark and Monk 2007a, 2007b; and Monk 2007). For all the issues raised, it has been difficult to rank-order their importance and tie increasing market competition in the context of tightening governmental controls to apparent changes in corporate benefit policy. In this article, the authors set out to do just that by considering the expert opinions of 1,266 U.S. survey respondents on these issues.

Significantly, the authors find widespread agreement as to the consequences of heightened market competition on the ability of private plan sponsors to
cover the costs associated with DB pensions. Yet, the authors also show that experts recognize the significance of impending liabilities for private plan sponsors’ future but, perhaps paradoxically, many experts also believe that those liabilities remain the responsibility of plan sponsors. This finding underscores the inherent problems with the current conceptualization of the DB pension promise. Indeed, the U.S. experts have deep-seated disagreements about the proper responsibilities of plan sponsors in the highly competitive, globalizing world. Some respondents are intent on holding firms accountable for past promises even if it may translate into corporate failure.

This raises fundamental questions as to the robustness of claims that the pension promise is best conceptualized as an “implicit contract.” Whereas public sector plan sponsors and trustees, government regulators and academics believe that this is the case, the survey results show that private plan sponsors, their trustees and, in some cases, the trustees of union-sponsored pension plans might well dispute this conceptualization. In response, an alternative view is suggested, because changing economic circumstances necessitate a new kind of conceptualization that emphasizes the contingent nature of pension contracting.

In this article, the authors focus on the United States, leaving aside, for the moment, comparative analysis of respondents’ opinions by country. Here, four general issues are considered: (1) U.S. respondents’ confidence in the long-term future of private DB pensions as well as their confidence in Social Security; (2) respondents’ opinions about the relative significance of market competition and regulation in driving the decline of DB coverage, noting the limited significance assigned to long-term risks; (3) respondents’ opinions about the nature and significance of the pension “promise” notwithstanding widespread recognition of the difficulties facing DB plan sponsors; and (4) the tensions observed by respondents between the interests of younger and older workers in companies that offer DB pensions.

Throughout, the authors distinguish between types of respondents, showing that it makes a difference on many issues whether experts are plan sponsors and trustees, come from public sector institutions, or are from government and academia. In general, expert opinion supports Ippolito’s (1985, p. 1,031) view that corporate pension plans are an “implicit contract” between the worker and the firm and that plan sponsors “intend to meet their pension promises.” But this general opinion is in specific cases contested by many private plan sponsors and is not the majority view shared by corporate plan trustees. The gap between implied intentions and actual responsibilities has implications for the interpretation of the pension promise—Even if those responsible for negotiating pension benefits intend to honor their commitments, those legally responsible for realizing those commitments may prefer a different interpretation of the pension promise.

SURVEY DESIGN AND IMPLEMENTATION

Considering the current debate about the status and future of DB pensions in private industry across developed economies, it has proven difficult to grasp the essential points of agreement and disagreement among the various stakeholders. Academic research has concluded that little can be done to reverse the decline of private DB coverage rates (Munnell 2006). The recent history of the institution in the United Kingdom, where the pace of DB plan closures has surprised even experts, suggests that these academic assessments are, if anything, cautious about the likely rate of DB decline in the U.S. private sector. At the same time, it should be acknowledged that what is true for the United Kingdom may not hold in the United States, where DB benefits have been tied, historically, to collective bargaining (Ghilarducci 2006). Likewise, the Dutch model of social solidarity may have very important implications for the negotiation of the future of the DB pension institution (see De Deken et al. 2006; Ambachtsheer 2007).

With the support of the British Academy, the Lupina Foundation (Toronto) and colleagues at Harvard University and the University of Toronto, a summit was convened in May 2006 at Oxford University to consider the prospects for private DB pensions. To inform the conversation, a background paper was prepared detailing the prevailing forces at work undercutting the institution, as well as the ways DB pension institutions may be reconceived to be relevant to 21st century financial and economic realities (Clark and Monk 2007a, 2007b). Among the 50 or so attendees were plan sponsors, trustees, labor representatives, actuaries and benefit lawyers, finance professionals, consultants, government regulators and academics. So as to gauge the level of agreement and disagreement on crucial issues, attendees were asked to respond to 27 statements. Results of this pilot survey were compiled and then distributed after the event.

After review, revisions and further trials, a new survey was launched in early January 2007 as an online instrument with the support of the newspaper and academic institutes and experts from around the world. In designing the survey, a number of issues were considered. First, it was crucial that the topics raised be
relevant to the history of DB pensions in a variety of settings. At the same time, it was clear that it should not be so general that its reach produced superficial conclusions of little relevance to any particular country. Second, it was important that respondents’ opinions be tested for coherence and consistency; there were thus overlapping and related questions included in the survey. Third, it was important that the survey allow for the assessment of opinions against core academic assumptions such as the “implicit contract” hypothesis. Fourth, the authors sought opinions on likely behavioral aspects of pension decision making such that responses could be matched against the behavioral finance literature (especially Kahneman and Tversky 1979 and Tversky and Kahneman 1991). This allowed for the collection of information and the evaluation of responses against recognized benchmarks (e.g., that most people are risk averse).

After an “open window” of about four weeks (beginning January 7, 2007), the data were collated into a composite file for analysis. Of the nearly 1,600 responses, roughly 1,300 were from the United States (of which 1,266 were complete). In terms of responses by the status of respondents, the table summarizes the distribution of respondents indicating that the largest group was from corporate plans, followed by money managers and service providers, public plans and consultants. Given the relatively large numbers involved, even a 5% response from a professional group translates into 65 respondents—more than enough to undertake statistical tests. Notice also that the weighted average experience was 15 years. As the discussion unfolds, little is made of difference of opinion by years of experience (comparing neophytes with old hands). Nonetheless, there are some differences in this respect, especially as regards the lack of confidence shown by neophytes in the future of employer-sponsored and state-sponsored retirement plans.

Any opinion survey has its drawbacks. These are considered in more detail in the conclusion to the article. Three are immediately relevant to what follows. First, opinions are one thing, behavior another. This is quite apparent in the psychological literature and can affect the implications drawn therefrom. Second, opinion surveys can never hold constant background commitments and obligations. People typically respond to questions or statements with what they think is the state of the world and what they believe should be the real world. Third, no opinion survey can control respondent interpretation of the meaning of questions or indeed the meaning of the whole survey. These issues appear and reappear through the survey and in the conclusion.2

**PRIVATE PENSIONS IN LABOR CONTRACTS**

Being formally recognized in labor contracts and subject to the collective bargaining process, DB pensions slowly claimed a foothold in major U.S. corporations throughout the latter half of the 20th century. As part of the negotiation process, the value of pension benefits became tied with the hourly wage, leading to improving benefits with each cycle of contract negotiation. Not only did the value of benefits increase, the nature of benefits broadened, including those attributed to surviving spouses. Whereas vesting periods were initially rather lengthy, each cycle of negotiation tended to reduce the minimum vesting period as unions and management played a game of leapfrog.
FIGURE

DB PLAN SPONSORS ARE CLOSING OR FREEZING THEIR PLANS PRIMARILY BECAUSE OF:

Source: Pension Insurance Data Book, 2005. PBGC.
(comparing benefits within and between firms and industries). In some industries, especially those subject to corporate and industrial restructuring, early retirement became an important mechanism for shedding workers (accompanied by enhanced pension benefits). By this account, the cyclical process of pension benefit negotiation and settlement added to the accumulated entitlements of workers—a classic case of commitment escalation as sketched by Staw (1982) and applied to the pension case by Monk (2007).

Given the evolution of the DB institution, the authors wished to test whether the experts agreed or disagreed with the contention (statement 16 of the survey) that “DB pensions were built incrementally over the course of 50 years; the escalation of commitment resulted in a large unexpected burden for sponsoring firms.” Clearly, respondents could agree with the first clause of the statement but disagree with the second clause of the statement (or vice versa), suggesting a likely high rate of negative responses. Nonetheless, just over 52% of respondents “strongly agreed” or “agreed” with the statement, with the highest level of support coming from corporate plan sponsors (56%) and their trustees (70%). No group disagreed with the statement, although there was a near balance of opinion for and against the statement by public pension plan sponsors and their trustees, and those representing union pension plans.

The DB pension promise has, in fact, escalated over time. It was thus crucial to gauge how the U.S. pension experts viewed the pension promise today. Asked their opinion, in statement 20, whether “DB pension deals are long-term contractual remuneration agreements for employees’ services,” there was overwhelming support for the statement among all respondents. In fact, no other statement elicited such strong and consistent support. No group recorded less than 80% support for the statement (combining “strongly agree” with “agree”). As such, despite acknowledgement on the part of experts that the pension agreement was changing and escalating over time, many still viewed pension benefits as they might have in 1949.

This brought to the fore an apparent dichotomy, since the promise has clearly evolved even if it has remained firmly entrenched in specific temporal and structural contexts. In order to test this idea, the experts were asked to give their opinion on (statement 17) whether “the embedded nature of the DB pensions system presents significant resistance to restructuring.” Here, there was clear support for the proposition (just about 60%) with the highest levels of support coming again from corporate plan sponsors and their trustees (61% and 70%, respectively). Significantly, union pension fund trustees disagreed among themselves over this issue with the balance of opinion just in favor of the affirmative. Not surprisingly, perhaps, was the high level of support shown for the proposition by money management firms, with 68% for and 23% against and the balance undecided. So, while the pension promise was clearly evolving over time, this evolution was taking place in a way that constrained flexibility rather than facilitated it. The fact that DB plans are considered significant impediments to restructuring threatens their sustainability due to the demands placed on sponsors in the context of fierce competition.

**COMPETITION, REGULATION AND IMPLICIT CONTRACTS**

Having established the significance of “history” for current stakeholders’ opinions about the nature and status of DB pensions, the authors sought to examine why plan sponsors are “closing or freezing their plans” (statement 24). Respondents were asked to rank-order five possible explanations, ranging from increasing costs to “unreasonable accounting rules.” The overall scores are displayed in the figure, where it is shown that “increasing costs” attracted 70% of respondents followed by “competitive pressure” (45%) to “accounting rules” (30%). Perhaps not surprising, the strongest difference of opinion was between corporate plan sponsors/trustees and government regulators/academics over the significance of “inflexible regulation” and “accounting rules”: The former group of stakeholders identified both as significant (about 40%), whereas the latter group identified both as rather less significant (about 16%). Undeniably, there is a disconnect between these groups over what is driving sponsors away from DB.

More generally, the significance of market competition for the declining importance of DB pensions was assessed in a couple of ways. Separate from statements related to “incrementalism” and “embeddedness,” respondents were asked to respond to the statement that “any organizational component that hinders a firm’s flexibility with respect to resources allocation and production decisions would put the firm at a disadvantage” (statement 13). There was a high level of agreement with this statement by corporate plan sponsors and their trustees (over 71% in both cases); somewhat lower support from public plan sponsors and their trustees (about 57% in both cases); and ambivalence about the issue shown by union trustees (about 40%). On the adverse impact of market competition, deregulation and globalization on private DB plan sponsors (statement 4), many respondents agreed that these issues were very important. Not surprisingly,
corporate plan sponsors and trustees, union pension plan trustees and, to a lesser extent, public sector plans and trustees supported the statement. Significantly, corporate plan sponsors and trustees consciously made a connection between competition, flexibility and their DB pensions, providing further evidence as to why DB plans are increasingly out of fashion. Other stakeholders, however, were not so convinced.

Turning to the impact of DB regulation, respondents were also asked for their opinion on (statement 19) whether “DB regulations and governance” were “overly restrictive.” Overall, the balance of opinion was in favor of the statement, but there were marked differences in opinion between stakeholders, none of which were surprising given the results presented above. Corporate pension sponsors and trustees clearly agreed (roughly 64%) and few disagreed (roughly 20%), and union pension plan trustees also agreed (about 55%) with only 22% disagreeing, while government regulators and academics clearly disagreed (about 48%, as against about 25% in favor of the statement for the latter group) as did public plan trustees (about 50%).

To test the overall significance of the issue, respondents were asked their opinion about the nature of the pension promise (statement 15): whether, in fact, regulation had transformed the nature of the pension promise from an “implicit contract” to a “contractual guarantee” (testing Monk’s 2007 argument). On average, all kinds of stakeholders agreed with the statement (45% agreeing or strongly agreeing, with 30% opposed). But corporate plan sponsors and trustees, as well as union pension plan trustees, were clear about their opinions (about 48% agreeing) with modest levels of disagreement between 20% and 30%. By contrast, opinion was mixed among other stakeholders including public sector respondents. These differences of opinion regarding the nature and significance of regulation for private DB pensions are important for understanding continuing debate over the purpose of public policy and the significance that should be attributed to the notion of a “pension promise.” Moreover, it exposes an undeniable miscomprehension about the nature of this pension promise between those that sponsor plans and those that regulate them.

On the issue of implicit contracts, two statements were posed about the responsibilities of plan sponsors “for all unforeseen contingencies stemming from long-term DB risks” (statements 18 and 22). When asked whether plan sponsors could take into account such contingencies, about 70% of respondents indicated that they could not (roughly 73% of corporate plan sponsors, 81% of corporate trustees and 85% of government regulators also viewed sponsors as incapable of preparing for all future contingencies). But when they were asked whether plan sponsors should be held responsible for unplanned future contingencies, opinions were split almost evenly overall and in almost every group for and against the proposition.

This is a remarkable finding, considering the apparent differences of opinion on other issues of market competition and regulation between private plan sponsors and regulators (for example). At the margin, corporate plan sponsors, but not their trustees, tended to agree that they ought to be held responsible, whereas union pension trustees tended to disagree with being held responsible. On these results, it is apparent that the notion of a DB pension as an “implicit contract” is not widely accepted in the industry and among those clearly responsible for its practical application. If experts anticipate the sponsor will cover all future contingencies, then the DB pension is, in its current form, an explicit contractual guarantee. Once again, this has serious implications for DB pension sustainability, as it gives credence to Monk’s (2007) “knot of contracts” explanation for DB pensions as legacy costs constraining corporate competitiveness.

**INTERGENERATIONAL EQUITY AND COMMITMENT**

It has been noted that there were widespread and high levels of agreement with the proposition (4) that increased market competition had adversely affected the competitive positions of private plan sponsors, and it was noted that, on balance, respondents agreed with the proposition (16) that the long-term development of DB pensions had resulted in large unexpected burdens for plan sponsors (most keenly felt by corporate plan trustees).

Since these issues touch on the durability of the DB institution in its current form, the authors also asked respondents whether they believed that DB pensions were “sustainable” in the sense that plan sponsors could meet current obligations without compromising the interests of future generations (statement 12). There was widespread agreement with this proposition (with 62% agreeing or strongly agreeing), led by the trustees of public pension plans and union-sponsored plans (74% and 79%, respectively). The groups indicating some doubt about the proposition were government regulators and money managers, where 35% and 37%, respectively, were against the proposition. On the other hand, when respondents were asked their opinion as to whether DB pensions “generate unknown and often negative effects for future generations” (statement 9), there was again widespread agreement with the proposition with the
highest scores recorded by corporate plan sponsors, their trustees and government regulators (59%, 61% and 58%, respectively). Disagreement with the proposition was led by public pension plans, union plans and consulting firms.

Reinforcing this point, respondents were asked their opinion about the apparent interests of different generations of plan participants. There was widespread agreement with the proposition (23) that “older workers nearing retirement” were “forceful advocates for DB pensions,” with total scores of “strongly agree” and “agree” consistently over the 55% mark. Likewise, it was generally agreed that “mobility and pension portability” (statement 10) are more important for younger workers than generous DB plans. In fact, the overall proportion of those agreeing or strongly agreeing with these two propositions was, in both cases, about 68%. At the margin, however, the strongest advocates for this position were corporate pension plans and trustees; those less enamored with the proposition were public pension plan sponsors, their trustees and the trustees of union pension plans. These opinions reflect, in large part, the reality that there are significant differences between generations of workers as to the value they place on different types of pension plans and savings (Mitchell and Utkus 2003).

It is recognized that DB plan sponsors face increasingly hostile market environments, carrying with them significant, often unplanned, DB pension liabilities for which they are deemed responsible. It is also recognized that DB pensions have the potential to adversely affect the welfare of younger workers, even if plan sponsors also believe that these issues can be appropriately managed. Not asked, in this survey, was whether their confidence in this matter is sustained or otherwise influenced by the existence of the Pension Benefit Guaranty Corporation (as a reader of a previous draft has suggested as relevant). Most importantly, corporate plan sponsors willingly carry these obligations into the future, notwithstanding very different claims for pension benefits by younger and older workers. One interpretation of this finding is some but not all corporate plan sponsors act as if there is an “implicit contract” with older workers rather than younger workers (who may, in any event, leave the firm).

**PLAN GOVERNANCE AND NEGOTIATION**

The commitments made by plan sponsors require a certain level of flexibility and innovation that may not be possible within inherited pension institutions (Clark 2007). Over a series of statements, the authors sought respondents’ opinion, as to the capacity of existing institutions and stakeholders to negotiate a future consistent with the apparent obligations undertaken by many plan sponsors to their older workers.

One set of questions dealt with the governance of pension funds, and the degree to which they were judged to be fit for the purpose. To test respondents’ opinions as to the role of plan sponsors in pension funds, they were asked whether plan sponsors had “too much influence over asset allocation” in DB funds (statement 7). The answer was a resounding no (with 58% disagreeing or strongly disagreeing, against 20% with no opinion)—a view shared by public and private plan sponsors, their trustees, money management firms and service providers. But notice that government regulators and academia had a rather different response than most other groups: Opinion in both groups was almost evenly split among “agree,” “no opinion” and “disagree,” with the extremes of “strongly agree” and “strongly disagree” recording quite low levels of commitment. It would seem that, in both cases, these respondents had insufficient knowledge of the issue to come to a shared view.

On the other side of the equation, did respondents think that fund asset allocation policies were caught between conflicting interests in benefit security and cost containment (statement 6)? Here, the balance of opinion was almost always in the negative, although government regulators, money managers and academics seemed to think that this was the case. Note, however, corporate plan trustees were quite divided about the issue. Most importantly, on the issue of trustee competence, private and union plan sponsors and trustee groups were deeply divided on the issue (statement 8). By contrast, public sector plan sponsors and their trustees were firmly of the opinion that the statement was not true: Trustees could be relied upon for their expertise in the “effective investment of DB assets.” Perhaps this reflects both their experience and their commitment to the “representation” function of many U.S. public employee retirement systems (Clark 2007).

The contentious nature of this issue is apparent in public debate over pension fund governance, as it is apparent whenever it appears on the agenda of conferences and industry seminars. The only available research of trustee competence and consistency suggests that many trustees are not as well equipped for their roles as they might be, especially given the complex tasks and functions facing any investor in the context of risk and uncertainty (Clark et al. 2007). The results of the opinion survey have served to amplify both the underlying disagreements about these issues among expert observers and the possible tensions about this issue at the level of fund boards and investment committees (Clark 2007).
Finally, a set of three statements were posed to test for respondents’ risk aversion (in a manner similar to Kahneman and Tversky 1979 and Tversky and Kahneman 1991). Responses were interesting but not particularly revealing as regards any underlying differences of opinion. When asked whether they believed that making a concession “with respect to future pension benefits” could be viewed “as accepting some degree of loss,” the overwhelming and consistent response across stakeholders was yes (except, perhaps, for consulting firms) (statement 14). When asked whether “accepting a certain but relatively small loss is preferable to accepting the possibility of a relatively large loss” (statement 11), the majority of respondents answered in the affirmative even though there were significant numbers in all groups that were uncertain as to their opinion. Would they make decisions that carried the risk of large losses in the future after they have gone (statement 21)? Again the answer was clearly and unequivocally no.

Given their knowledge of the pension industry and their current responsibilities for the future of DB pensions, the respondents were clearly risk averse. By implication, whatever their roles in the industry, they are incremental decision makers rather than risk-seeking innovators. This coincides with our affirmative findings that DB pensions were built incrementally, as commitments escalated over time.

**CONCEPTUALIZING THE DB PROMISE**

Ippolito (1985, 1031-32) followed Treynor (1977) in suggesting that “workers anticipating careers with a firm will consider the package of wage and pension benefits they expect to collect over their life cycle.” He contended that “these expectations imply “the pension contract is written in real terms; that firms intend to meet their pension promises; and that the firm will retain the plan intact and pay pension liabilities that are either implicitly or explicitly indexed to the final wage.” As noted above, the respondents overwhelmingly supported the notion that “DB pension deals” are “long-term contractual . . . agreements for employees’ services and/or support” (statement 20). They also supported the statement that these types of long-term commitments “generate unknown and often negative effects for future generations” (statement 9), although there were decidedly mixed views as to whether plan sponsors are obliged to honor their long-term pension obligations because of the existence of significant “unforeseen contingencies” (statements 16, 18 and 22).

Here, an important implication to be drawn from our survey results is that a significant number of respondents believe DB pensions to be guarantees, not just “promises” or “implicit contracts.” Indeed, a promise between individuals is typically recognized as being “breakable” in times of distress since, in everyday life, personal exigencies frequently trigger renegotiations (Williams 2002). While some readers may find solace in the fact that opinions were split on the issue, the authors would contend that the split is over the extent to which respondents agree or disagree about the pension contract, as opposed to the pensions promise. Reinforcing this argument, it is instructive that a majority of respondents also agreed or strongly agreed that DB implicit contracts have been “changed by regulatory intervention” into contractual “guarantees” (statement 15). Results suggest that there are respondents who interpret DB pensions as a “promise” that carries the full weight of moral expectations (a normative claim) underpinned by a regulatory injunction with the force of law, instead of having to rely upon the goodwill of private parties.

The idea that a contract embodies moral obligation because it is a promise to behave in a certain way in the future is widely held and can be found in Fried (1981), among others. Fried argued that the practice of contracting relies upon a deeply embedded sense of what the parties to a contract owe to one another—a commitment to the relationship and, by extension, to the terms and conditions of the agreement. He argued that “contract as promise” is legitimate by virtue of the fact that the contracting parties come to agreement freely and without coercion—They willingly bind themselves to the relationship, even knowing that in the future there may be unanticipated opportunities (or costs) of which they could take advantage but which they nonetheless promise to ignore. He also argued that “contract as promise” is a trust relationship such that those involved can rely upon one another to carry through on their freely made obligations; reliance in each part of life cascades through agents’ other relationships to form a web of commitments underpinned by a commonly accepted moral order.

The relevance of this view of the DB pension promise can be shown in a number of ways. For instance, it is apparent that U.S. DB pensions have been deeply embedded in the ongoing relationships between sponsoring labor and management institutions over many years. Where the rate of labor productivity, capital utilization and corporate profitability are the product of such relationships, DB pensions can be seen as a reflection of those commitments rather than a discrete, single item agreement. Similarly, that these relationships overlap, are reinforced, and are made and remade through negotiation suggests that the DB pension promise carries that force of common agreement rather than coercion or grudging acceptance.
And, finally, that these commitments have been made and trust relationships formed, it is hardly surprising that those involved come to rely upon those commitments in terms of their expected welfare. In this respect, it is arguable that the DB promise is a promise in a deeper sense than the relationship between the plan sponsor and its shareholders.

However, in their study of leveraged buyouts and plan terminations, Ippolito and James (1992, p. 155) suggested that implicit contracts are contingent upon the current and future economic prospects of the plan sponsor and can be revised if circumstances warrant. This view is consistent with most economic theories of contracting. For example, those that hold to a discrete-transaction view of contracting contend that it is more efficient to continuously revise and adapt contracts than hold one or both parties hostage to prior commitments. This argument is at the heart of the Chicago school of law and economics. Even those that hold to a relational view of contracting recognize the significance of changing economic circumstances. For MacNeil (1980, p. 31), a common awareness of this possibility encourages the partners in any long-term bilateral agreement to plan for such eventualities going well beyond observance of conventional norms and customs. Either way, “market exigencies” can trump an implicit contract.

But, what counts as legitimate market exigencies? Ippolito and James suggested that leveraged buyouts and plant closings are events “broadly consistent” with “the exigency provision in the implicit contract notion.” But these are extreme events. One interpretation of the extreme exigency provision is that it protects the pension promise until the plan sponsor is exhausted by market forces. In effect, up until such a crisis, those bound by long-term “implicit contracts” are neither willing to adapt to changing circumstances nor plan for the future so as to avoid worst-case scenarios. It was noted above that a large majority of respondents, and especially corporate plan sponsors and their trustees, affirmed the statement (17) that “the embedded nature of the DB pension system presents significant resistance to restructuring.” The authors also noted that, contrary to MacNeil (1980), effective planning for “unforeseen contingencies” is highly unlikely given our respondents’ predilections for incremental, risk-averse decision making.

Many of the respondents are not economic or legal theorists. But in interview and in commentaries on the nature of the DB promise, the authors have often observed that industry participants deploy the principles of “contract as guarantee and promise” when protecting the DB institution from criticism. Notwithstanding Williams’ (2002, pp. 111-12) confidence in the innate flexibility of common commitment and belief in one another’s trustworthiness, the pension promise emerges as an absolute rule (until it fails absolutely).

**PENSION BENEFITS AS CONTINGENT PROMISES**

It is clear that the majority of private pension plan sponsors and a large portion of trustees in the survey look askance at the DB promise, disputing implicitly or explicitly commonly made arguments that DB pension benefit commitments have the force of a moral obligation. Rather, they accepted that DB pension benefits have the force of law including contractual rights and those created by ERISA. But they are under no illusion as to the costs and consequences of past agreements that have produced unanticipated and growing long-term pension liabilities. It is also apparent that

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many of the respondents recognize that past promises, transmogrified into pension guarantees, have imposed large financial burdens on plan sponsors. Nonetheless, they appear unwilling to reconsider (outside of bankruptcy) the terms and conditions of past agreements such that those burdens may be discounted or distributed among the various stakeholders. This is, oftentimes, justified by the reliance of older workers on DB pensions, given the lack of alternative employment and income opportunities in many of the communities in which they are located (Monk 2007).

Private DB pensions have become a means of ensuring older workers’ prospective livelihoods in circumstances where corporate and industrial restructuring have changed the very shape and form of the modern corporation (Clark 1993; Jensen 1993). While private DB plan sponsors and their trustees are locked into commitments they would not otherwise willingly assume, it is arguable that private plan sponsors have sought “flexibility” in the provision of pension and retirement benefits by encouraging newer employees and younger workers to take up DC pension plans, cash balance plans and related benefits. Given a nonnegotiable commitment to the welfare of older workers, this commitment has been paid for by plan sponsors through the introduction of other kinds of pension benefit systems that shift the risks associated with benefit value to participants, rather than remaining against the market capitalization of the sponsoring firm. That DC schemes shift risk to employees is widely recognized and is reasonably justified by the interest of younger workers in benefit portability (something recognized by respondents).

In many cases, especially in the early years following the introduction of 401(k) plans, workers were given a choice of which type of plan to join. Where possible, however, large private plan sponsors have sought to close DB plans to new entrants, while offering matching contributions to DC plans as well as retirement savings plans that have included company stock options and the like (Ramaswamy 2003). Indeed, those companies not subject to unionization, operating in industries where labor turnover has been relatively high and subject to significant cost pressures in terms of market competition, have not offered DB pensions, preferring, instead, a mix of DC and savings plans that fall far short of the value of traditional DB pensions. In these cases, it is arguable that pension benefits are contingent upon employee status where status is read as their own aspirations for retirement income as well as their conditional commitment to the sponsoring firm. No group of employees by age claim a privileged position over all other employees in terms of the commitment of the plan sponsor to their final retirement income (except senior executives; see Bebchuk and Fried 2004).

The discounting of pension benefits implicit in the shift from DB to DC plans has been noted by many commentators (Munnell and Sunden 2004). There are, no doubt, significant long-term welfare consequences, including higher levels of retirement income inequality, implied by the long-term decline of DB pensions in U.S. industry. While there are some commentators who have sought ways to hold private plan sponsors to the DB institution, recognizing these sentiments are shared by many respondents to our survey, it would seem that private plan sponsors and their trustees are acutely aware of the likely costs of such commitments and have sought, one way or another, ways of facilitating a shift toward other kinds of retirement income plans even if locked in to a long-term commitment to their older employees. Other commentators are more sanguine, arguing that greater flexibility in terms of the nature and value of offered pension benefits matches the workers’ preferences, the lifecycle of firms and the remarkable diversity of labor turnover patterns in American industry (as documented in Brown et al. 2006).

In these cases, it is arguable that private plan sponsors make a pensions promise in terms of the contributions to employees’ chosen retirement income or savings vehicles. This “promise” makes no commitment as to final benefit value—nor does the promise embody an implicit commitment to older workers over younger workers—but it is a promise nonetheless in the sense that it is a financial commitment subject to an employer’s capacity to play and is protected as such by employment law and related contract law. Note, though, in these circumstances pension plan participants are not privileged bondholders but are more reasonably understood as creditors who have a claim like other creditors on the current income of the plan sponsor, whether as a going concern or as a liquidated entity. As long as contributions are paid to employees’ retirement accounts as they are paid their hourly or monthly salaries, no further commitment or “promise” need be considered by arbitrators or the courts. In this sense, DC pension benefits are contingent promises—being contingent upon plan sponsors’ current revenue, expected market performance and employees’ commitment to the firm.

In this respect, it is not surprising that experts and government policy makers have sought to remake the DB pension institution by encouraging the formation of multiemployer and even mandatory national employment-based pension savings schemes that take the weight off individual plan sponsors. Advocates of such schemes argue that these types of institutions
would have sufficient size and scope to underwrite the value of individual DB pension benefits, while being responsive to the flux and flows in corporate life. Here, the experiences of Australia, Canada and some Scandinavian countries are relevant, just as tentative steps toward the introduction in the United Kingdom of the national pension savings scheme may be a model for the future. However, these issues and possible solutions were not the subject of the survey, even though comparing respondents across countries shows evidence of quite different expectations according to the path of development of national employer-sponsored pension systems.

By this account, the authors would argue that plan sponsors have always sought contingency, while the original DB pension promise, an implicit promise, was transformed into a promise without reasonable contingency provisions, sponsors instinctively reacted with new parallel contingent pension mechanisms. Perhaps recognizing the risk of the long-term explicit guarantee associated with the changing legal conception of the DB promise, sponsors’ shift toward DC and other options can best be explained by firms’ desire to recapture contingency and flexibility.

**CONCLUSIONS**

The prospects for U.S. private DB pensions are normally discussed by reference to the long-term transition to DC plans—Not only do 401(k) plans now have many more participants, but recent evidence suggests that the total value of assets in DC plans outweighs the value of assets held in DB plans (Munnell 2006). This “transition” is explained in many ways, often appealing to the costs of administration and regulation imposed on DB plan sponsors, the risks borne by DB plan sponsors and the implied company share price discount, as well as the demand for DC benefits by younger workers (especially leading up to the stock market bubble of the late 1990s).

In this article, the authors sought to calibrate the relative significance attributed to these explanations of the long-term decline of the DB institution, relying upon the opinions of over 1,266 experts with a weighted average 15 years of experience drawn from the U.S. pension industry.

The results of the opinion survey have been summarized in previous sections. Nonetheless, three findings are particularly significant for the debate over the causes and consequences of the decline in private U.S. DB pensions. First, when asked to rank-order the reasons for the closure or freezing of DB plans, respondents chose to emphasize increasing costs (by far the most important issue) followed by competitive pressures. Both are related to the economic costs and competitive market positions of plan sponsors, and it is not surprising that respondents overwhelmingly agreed that the decline of private DB pensions could be directly related to “deregulation and globalization.” Considering the largest U.S. private DB plan sponsors are to be found in the Standard & Poors’ 500 (S&P 500), and in many manufacturing and industrial sectors subject to increasing competition inside and outside domestic U.S. markets, these opinions are entirely plausible. However, unlike other countries, notably the United Kingdom and Australia, U.S. respondents believe “unquantifiable risks” to be marginally less important than “inflexible regulation.” In fact, U.K. respondents identified “unquantifiable risks” as the second most important factor contributing to the decline of private DB pensions.

A second issue of importance has to do with the issue of intergenerational equity and commitment. The respondents surveyed clearly recognized that older workers have the largest stake in DB pensions. They also recognized that younger workers have an interest in benefit portability, given their prospects for job switching and mobility. In this context, the authors asked whether DB pensions were sustainable (comparing the interests of different types of workers). Many respondents answered in the affirmative, including corporate plan sponsors and their trustees. Not convinced were government regulators and academicians. But these answers are difficult to square with the fact that many of those who answered in the affirmative also answered that DB pensions often generate “unknown and negative effects for future generations.” At issue, then, is the degree to which plan sponsors, their trustees and related stakeholders can negotiate solutions such that there is a way of reconciling competing interests. Here, however, the evidence suggests that the capacity for innovation is quite limited: Many respondents indicated that they would only act incrementally and would pursue risk-avoidance strategies rather than a significant long-term realignment of interests.

Finally, the results challenge the extent to which DB pensions are or should be conceptualized as an implicit contract between plan sponsors and their older employees. This notion has widespread support in the academic community due, no doubt, to recognition of some of the tensions and competing interests identified in this article. Perhaps it is true that some groups in the industry do or would conceptualize DB pensions in these terms. The authors contend, though, that plan sponsors and especially their trustees are less enamored with the notion. Given the significance attributed by these respondents to the
declining competitive situation of sponsoring firms, as well as their reluctance to accept responsibility for unforeseen contingencies,” another way of conceptualizing their notion of the pension promise is as a “contingent commitment.” This would not find favor with many of the respondents surveyed in this article. But it could be closer to the interests of private plan sponsors and trustees, and may encourage a longer term commitment to the DB institution.

Endnotes

1. Nonetheless, it should be noted that U.S. expert opinion is closely correlated with Canadian expert opinion. In many cases, there is no statistically significant difference of opinion. On the other hand, there are significant differences of opinion between U.S. experts and U.K., European and especially Australian experts.

2. Due to space constraints, the findings (charts) and discussion have been cut short in this version. For more details, please download the working paper: www.ouce.ox.ac.uk/research/transformations/wpapers/.

3. The questionnaire in its original order can be found at the conference Web site: www.ouce.ox.ac.uk/news/phclcs/.


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Would It Have Mattered?
The Consequences of Favoring Short-Term Budget Goals Over Long-Term Retirement Policy

by Stuart A. Sirkin and Sonja J. Coffin

Government policies toward defined benefit plans over the last 20 years often focused on short-term federal budget accounting rather than long-term retirement needs. In reviewing the history of U.S. pension policy, the authors argue that government policy focused on the retirement needs of workers and the concerns of defined benefit plan sponsors would have made a difference in the retirement benefits of today’s middle-class workers. Although the decline in the defined benefit system was inevitable due to larger forces like globalization, those workers’ defined benefit plans might not have been frozen or terminated in recent years.

Many experts argue that the slow death of the defined benefit system was, and still is, inevitable. They argue that market economics and global trade make the defined benefit plan a creature of another age—an age when U.S. manufacturing was king and the unions were powerful enough to avoid competition based on labor costs. In today’s “flat” world of global trade, cheap labor is a key component of competitive success, and the idea of a well-paying, lifetime job in manufacturing is antiquated.

The authors certainly recognize that the world is very different today than it was when defined benefit plans were king. It is likely far too late, and probably not desirable, for today’s workers to rely on employer-provided defined benefit plans to provide lifetime retirement benefits starting at the age of 55. But the authors must wonder whether different government policies over the last 20 years would have made a difference to today’s older workers—not government policies that would have limited global trade or the birth of new industries, but rather policies over the last 20 years that focused on long-term retirement needs rather than short-term federal budget accounting.1

Would it have mattered? It is easy to sit here now and criticize. The authors believe in the worth of defined benefit plans as retirement vehicles. If nothing else, different policies would have led to better plan funding when the “perfect storm” hit. And better advance plan funding would have meant less need to terminate and freeze plans, because the volatile increase in contribution requirements would not have occurred. However, the authors are realistic enough to know that powerful economic forces and global market realities in the other direction probably would have been too strong to preserve defined benefit plans.

Part I of this article discusses how today’s current retirement world came about. Part II sets the stage for the Pension Protection Act of 2006 (PPA), and Part III sets forth the fundamental debate between protecting the Pension Benefit Guaranty Corporation (PBGC) and maintaining the defined benefit plan system. Part IV addresses the good and bad of PPA, and Part V discusses the impact of the accounting rules.