Addressing Inflation in the Design of Defined Benefit Pension Plans

> *"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens."*
> *~ John Maynard Keynes*

A long standing criticism of public sector defined benefit pension plans is that, unlike their private sector counterparts, public plans typically provide for inflation related adjustments to retiree benefits (commonly called COLAs). The common assertion is that since there is a difference between the public and private sector in this regard, the public sector must be wrong. If you are among the naysayers, the following may not change your mind about who is getting it right but, at least, it should help you become a better informed critic.

However, before addressing COLAs there is another issue related to public/private distinctions that I believe may benefit from a dose of factual information. Many people will probably wonder why even bother to compare public and private sector defined benefit plans because it is "common knowledge" that defined benefit plans have all but vanished from the private sector landscape. If you are among those who have that impression, please refer to the information in the sidebar.

Now on to the subject of COLAs, starting with a few points that I believe to be generally accepted considerations:

- The purpose of a retirement plan is generally to allow people who are not able to work because of advancing age or disability to leave the workforce with dignity and continue to be financially self-sufficient during retirement
- Some level of inflation is to be expected and, in fact, most economists believe it is necessary for economic growth
- In financing public and private sector defined benefit plans, the assumptions regarding future return on investments include an inflation component, typically in the area of 3% plus or minus ½%

Let's assume that plan participants should have financial resources that will last at least 20 years following retirement. With a 20 year time horizon, the following schedule illustrates the impact of various rates of inflation on the remaining purchasing power of $1 at the end of the period relative to $1 at the beginning of the period with no COLA.

Impact of 20 Years of Inflation
on Purchasing Power of $1.00

Period *	Average CPI Rate	Purchasing Power Left
1991 - 2011	2.6%	$0.60
80 Year Average	3.4%	$0.50
1965 - 1985	6.3%	$0.30

** Periods ended March 31*

The rate of inflation over the past 20 years has seemed somewhat benign, particularly to those who were trying to make ends meet in the 1970s. However, at just 2.6% per year, a dollar loses 40% of its value in 20 years. At the long term average of 3.4% the loss over 20 years is half of the value. Those who believe in reversion to the mean (not to mention a number of other current factors) are expecting something in excess of 3% inflation prospectively. Finally consider the person who retired in 1965 with no COLA – at the end of 20 years, a fixed dollar benefit had lost 70% of its value.

The decision regarding whether or not defined benefit pension plans should include a COLA provision in the plan design is, indeed, a policy decision. However, there is a serious question regarding whether or not plan sponsors with no COLA provision should have the latitude to ignore that fact in describing the benefits provided by their plans. By federal law, private sector plans must provide participants with summary plan descriptions that are calculated to be understood by the average plan participant. By practice, public sector plans commonly do the same thing. Ostensibly, the purpose of these documents is to permit plan participants to make informed decisions regarding their financial futures.

As long as they are working, employees typically have an awareness of inflation but they are probably not giving it serious consideration for long term planning purposes since wages will eventually be adjusted for at least some portion of inflation. Accordingly, they do not have experience in planning for a protracted period during which inflation will be impacting their expenses but not their income. This brings to mind two of the current industry buzzwords that come up in one way or another on almost a daily basis – sustainability and transparency.

The Vanishing Private Sector Defined Benefit Pension Plan?

As of September 30, 2010 there were approximately 44.2 million workers and retirees participating in approximately 27,500 private sector defined benefit pension plans. *Source – 9/30/10 PBGC Report*

Last year plan sponsors of the 100 largest private sector defined benefit pension plans reported their pension expense for those plans for the year being about $60 billion. In accounting for those private sector plans, the average expected rate of return on assets was 8%. *Source – Milliman, Inc.'s 2011 Pension Funding Study.*

In order to have a sustainable standard of living during retirement, active employees need to begin planning as early as possible. Since inflation is not an everyday consideration while working, efforts should be made to elevate active employee awareness of its potential impact on lifestyle sustainability during retirement if their pension has no COLA. This leads directly to transparency with respect to the obligation of a plan sponsor with no COLA to notify active employees that, by design, their pension plan will, over time, probably be paying them off at pennies on the dollar. (This has particular relevance in the common case where the plan sponsor is consciously funding the benefit with the expectation of receiving inflation generated investment return.) Consequently, participants in plans with no COLAs need to be planning to somehow make up for the shortfall due to the eroding purchasing power of their retirement benefit dollars if they hope to sustain their standard of living. In fact, it is a little surprising that the Department of Labor's Employee Benefit Security Administration has not mandated such disclosures.

This all takes us back to the initial question: Is it the public sector or private sector that is getting it right with respect to COLAs?