An Integrated Approach to Pension Benefits

by | William J. Ruschau

The search for the perfect pension system, like the search for the Holy Grail, continues to prove elusive. The economic collapse of 2008 and ongoing roiling of the investment markets brought into focus the uncertainties involved in providing a secure, adequate, lifetime pension benefit to workers at the end of a long career.

The current approaches clearly fall well short of nirvana. Pension plans generate substantial risk for both employers and workers in the form of withdrawal liability, unfunded benefits, insolvency and the like. Defined contribution (DC) or savings plans eliminate the cost uncertainty, but also eliminate benefit certainty for the retiree.

Conflicting Objectives

It is clear that employers and workers have very different objectives for a pension system. Employers generally are looking for:

- Cost certainty
- Minimal risk of withdrawal liability
- Stability over extended periods.

In addition to the cost/risk elements, though, employers also have an interest in maintaining a system that enables older workers to retire. In many industries, the building trades being a prime example, the work is physically demanding and the ability of workers to continue being productive declines as the years take their toll. A system that enables older workers to retire and to replenish cost certainty to employers and enhanced benefit security to retirees. This article will explore one such approach.
Combining both a traditional pension plan and a defined contribution plan, and adding a mechanism to turn the DC savings into a lifetime income option may resolve some shortcomings of retirement plans.

ish the workforce with younger members is a significant element for long-term success for such industries.

Workers have other objectives for a retirement system:
- Adequate benefits
- Lifetime security
- Simplicity.

The main problem with meeting all of these objectives is the uncertainty of the financial markets. If benefits are nailed down, as through a traditional defined benefit pension plan, costs must necessarily fluctuate as the markets change. For example, assume that a plan must accumulate $100,000 at retirement to provide the desired pension benefit to a member. That accumulation comes through a combination of employer contributions and investment return. If the return drops, contributions must increase to make up that difference, or the benefits must decrease to a level that can be supported by the existing contributions. On the other hand, if the contributions are fixed, as through a DC plan, the benefits provided will vary as markets vacillate. A given contribution level might produce $100,000 of benefit, or $200,000 or $50,000.

The Integrated Approach

As we cannot control what the markets will do, we can never fully meet all the pension objectives for both employers and workers. However, by combining approaches and taking some of the best elements of each, we can get to a position that reduces many of the risks for both employers and workers. The basic approach has three steps:

1. Provide a core level of benefits through a traditional pension plan.
2. Provide enhanced benefits through a DC plan.
3. Provide a mechanism for members to convert their...
DC accumulations to a secure, lifetime pension benefit at retirement.

Many sponsors today utilize these first two steps, providing both a pension benefit and a DC or savings plan benefit. Although few take the third step, it is possible to structure a conversion mechanism to provide benefit security to retirees with minimal risk to employers.

Basic Benefit Levels

Before discussing this third step, let’s take a look at the basic plan contributions and benefits. The definition of what is a core benefit level will vary by industry and by plan. In many cases, benefit accrual levels have been reduced in recent years to help offset the adverse markets over much of the early 21st century. It is doubtful that overall benefit rates will ever return to the heady levels of the 1990s, when annual double-digit market returns fueled a spike in pension benefits—a spike that proved to be not supportable in the long run when markets flattened and declined.

The issue for plan sponsors to address is how much of the total future retirement benefit should come from a traditional pension benefit and how much from a supplemental DC benefit. Corporate America has essentially answered this question by eliminating pension benefits and moving entirely to DC plans. But it is not necessary that multiemployer plans go this same route. If the pension plans can be returned to a fully funded status and investment risk reduced through appropriate adjustments to investment strategies, such plans can continue to provide meaningful benefits for workers with significantly less risk for employers.

Providing enhanced DC benefits doesn’t necessarily involve an increase in the total pension cost. The typical pension plan contribution today can be looked at as being comprised of two elements:
1. A piece to pay for the current benefit accrual for the active members
2. The remainder to fund the unfunded benefits for current and prior members.

Once past benefits have been fully funded (perhaps with a margin to protect against future adverse markets), the second component of the contribution rate can be redirected to a DC plan.

Taking this approach reduces the likelihood of withdrawal liability for employers in multiemployer pension plans by increasing the chances that pension benefits will remain fully funded. And if adverse experience is such that unfunded benefits do emerge, any withdrawal liability payments may be reduced by the lower contribution rates. (Withdrawal liability payments are tied to the highest contribution rate in the preceding ten years, and diverting some of the pension contribution will eventually reduce this rate.)

Securing the DC Benefit

While shifting a portion of the contributions and benefits to a DC plan addresses many of the employer concerns, it heightens some of the member concerns. Instead of a clearly defined lifetime pension, the member receives a pot of money with which to meet his future financial needs. Spend it down too quickly, and he will run out of money in later years. Spend it down too slowly, and he may suffer a decreased standard of living because of inadequate income. This problem would be easy to solve if
a person knew how long he was going to live after retirement, but even the most astute actuary can’t tell him that.

The solution, then, is to convert the DC account into a lifetime pension benefit, or annuity, at retirement. While anyone can do that now by purchasing an annuity contract from an insurance company, the conservative pricing, agent commissions, margins, expenses and profit loaded into the insurance pricing tend to make this option unattractive. A better approach is for the plan sponsor to permit the pension plan to “sell” the annuity to the member. At retirement a member could choose to transfer some or all of his DC account to the pension plan to receive a lifetime pension income. And not just any pension benefit. The benefit can be structured as follows to overcome many member and sponsor concerns:

- The benefit would be a variable annuity.
- There would be a guarantee that the benefit could never be less than the initial amount.
- There would be a guarantee that the member would always receive back at least the amount of money he transferred to the pension plan.

The first element largely eliminates additional risk to the pension plan. The latter two address member concerns for security in the amount of the benefit and to make sure he cannot “lose” some of his original DC benefit. A recent Internal Revenue Service ruling, Revenue Ruling 2012-4, addressed many of the issues and resolved some uncertainties regarding the transfer of assets from a DC plan to a pension plan.

Variable Annuity

Variable annuities have been around for nearly 50 years but have not drawn much attention until recently. The concept of the variable annuity is pretty straightforward. The benefit amount increases or decreases based on investment return above or below a target or hurdle rate. For example, if the hurdle rate is 4% and the fund earns 7%, the benefit increases by roughly 3%. If the fund earns 0%, the benefit declines by roughly 4%. Hurdle rates typically are set in the range of 4% to 5%. Because this is less than what the fund might expect to earn over time, the expectation is that the benefit is likely to increase more often than it decreases. The guarantees that the benefit can never be less than the initial benefit amount and that the member will always get back at least his original investment (a cash refund annuity in actuarial speak) can be accommodated by careful pricing of the annuity purchase rates.

Effect on the Pension Plan

From the pension plan perspective, the receipt of the DC balance and issuing of the annuity involves very little risk. Investment risk is substantially all with the participant benefit. It would require a sharp, prolonged downturn shortly after the annuity is established to generate any significant loss. There is a slight amount of longevity risk from members living longer than expected, but that is minimal. Revenue Ruling 2012-4 suggests that the transfer should use the actuarial factors defined in the Internal Revenue Code for the determination of lump-sum benefits. The mortality assumption for that is fairly conservative, especially for a typical multi-employer plan, so significant mortality losses are not likely. In aggregate, the assets and liabilities associated with these transfers are expected to remain approximately equal over the lifetime of the benefit, regardless of actual experience. (As a side note, this transfer into the plan at 100% funding will increase the overall plan funded percentage for any plan that currently is less than 100% funded.)

In most cases the same pension trustees manage both the pension plan and the savings plan for a plan sponsor. They have a fiduciary obligation to both plans to make sure that the transfer is equitable to both.

Effect on Member Benefits

From the member’s viewpoint, the combination of a pension and DC plan with a transfer option addresses many benefit security concerns:

- The transfer from a tax-qualified plan to another tax-qualified plan constitutes a direct rollover that will not be immediately taxable so long as it is properly structured.
- The participant can never outlive his benefit. The annuity payment is guaranteed for life.
- The participant will always get back at least his initial investment into the pension plan. This removes a frequent member concern about not receiving all of his benefit.
• While future payments will increase or decrease with future investment performance, the member has a secure floor for his pension income.
• Because the fund return is expected to exceed the hurdle rate over time, there is a degree of inflation protection anticipated in the benefit.
• The member can choose how much of his DC balance he wishes to annuitize. Thus he can first buy a bass boat, a Florida condominium or whatever his retirement dream is, and then annuitize the rest.
• Moreover, use of the pension transfer is completely at the member’s option. Members not wishing to secure their benefit in this manner are not compelled to do so.
• DC accumulations are simple to understand and follow while the member is working. The plan can publish sample benefit conversion factors to let members easily estimate the monthly income they can get as retirement approaches.

Member Risks

While this DC-to-pension transfer has many positive elements, some risks or negative elements must also be considered. It is important to make sure members know all of the issues to make an appropriate election. Key concerns are:
• The biggest risk, and most important consideration, involves insolvency of the pension plan. Revenue Ruling 2012-4 indicates that these transfers are treated as a distribution from the pension plan and as mandatory employee contributions to the pension plan. While this distinction is important for a corporate plan termination, it has no effect on a multiemployer plan termination. The benefits from the transfer are treated as any other benefits and subject to reduction or elimination upon insolvency. The pension plan can enhance security for members by making the transfer option available only if there is an actuarial certification that the plan is expected to remain solvent for at least 25-30 years. In all cases the member will receive back his initial investment within 20 years, and often in a much shorter period. The additional years of solvency provide some extra margin, though it is not possible to protect against every market possibility.
• As mandatory employee contributions, the benefits from the pension plan would presumably be subject to spousal consent and a joint and survivor option, even if the original DC plan was not. However, because the transfer is optional to begin with, a member can address the issue with his spouse before making use of this provision. The joint and survivor option can also be a variable benefit, with or without the other guarantees.
• Benefit guarantees do not come without a cost. The guarantee of a minimum benefit level and a return of contributions will decrease somewhat the amount of monthly benefit available. For example, if a given distribution may have purchased a $500 per month benefit without these guarantees, the benefit might be only $425 or $450 with the guarantees included. The actual cost of these guarantees requires some sophisticated actuarial pricing.
Summary

As multiemployer plan sponsors continue to look for ways to decrease risk, DC plans are becoming an increasing part of the retirement benefit structure. And with the market collapse of 2008 fresh on the minds of participants and ever-growing life expectancies, the security of their retirement benefits is an increasing concern. Plan sponsors can address many of the concerns for both employers and members by providing a combination of pension and savings plans, and by providing an option for members to secure their savings plan benefits at retirement. Properly structured, this can be done with a minimum of risk to the pension plan, while eliminating many of the risks for the members. This can be a win-win for plan sponsors and their constituents.

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