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PLAN CONSULTANT

SPRING 2014

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Reprinted from the Spring 2014 issue of ASPPA's Plan Consultant. The American Society of Pension Professionals & Actuaries (ASPPA) is an organization of actuaries, consultants, administrators and other benefits professionals. For more information about ASPPA, call 703.516.9300 or visit the website at www.asppa.org.

The Combined Plan Approach

BY KEITH KOWALCZYK

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A traditional DB plan and a DC plan working in concert is good for the sponsor — and great for participants.

Defined benefit plans are the most cost effective qualified plan design in two key areas: (1) rewarding longer-term employees because of the pattern of benefit accruals; and (2) providing a lifetime income stream by pooling the longevity and investment risks. But they also inherently pose two major risks: (1) fluctuating contributions; and (2) potential unfunded liabilities objectionable to the plan sponsor and its accountant.

The advantages of DB plans are clear:

- The "J" pattern of benefit accruals, amplified in salary related plans, results in very low accruals in early years, with accelerating mid-career accruals and very rapid accruals just prior to retirement. Therefore a DB plan can reward longer-term participants with the savings from early terminations.
- Higher returns may be achieved because the plan's assets can be invested more aggressively, recognizing the time horizon of the entire plan population.
- Higher lifetime income levels are achieved in DB plans by balancing the gains and losses of those who outlive a normal lifetime with the gains and losses of those who don't.

The main deterrent to utilizing a DB plan is its inherent instability because of the mismatch of the assets and liabilities. Defined benefit plan liabilities are very long-term fixed income obligations, while the investments underpinning those liabilities are mostly stocks and intermediate-term bonds. However, this relative instability of a diversified portfolio based on the demographic time horizon of a plan's population may allow the plan to garner higher returns over time.

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A TALE OF TWO ERAS

During the first era that lasted through the 1990s, this mismatch generated substantial excess of assets over liabilities resulting from gains on both sides of the balance sheet. Interest rates rose through the early 1980s, with the 10-year Treasury rate peaking at just over 15% (according to Federal Reserve Bank of St. Louis), depressing plan liabilities. Actuaries raised their assumed earnings rates, which painted an even brighter financial picture. On the other side of the balance sheet, plan assets ballooned thanks to favorable equity performance throughout this era.

At the end of the 20th Century, the inherent instability in DB plans proved to be a windfall for all — many plans increased benefits and corporate America took contribution holidays for many years or even raided their overfunded DB plans to reap the excess assets for corporate gain.

The second era, often dubbed "the lost decade," began with the collapse of the excesses of the dot-com bubble in 2000. The perfect storm of declining interest rates and near-zero or negative stock market returns crippled the DB system almost beyond repair. The declining interest rates made plan liabilities skyrocket; at the same time, plan assets not only fell short of the 7%-8% actuarial assumption, but were actually negative. In just three short years, plan assets took a nose-dive from substantial excesses to substantial deficits.

Beginning in 2003, DB plans got back on track, but their recovery was short-lived. Unexpectedly, the Great Recession revealed that the inherent instability could be devastating in just one year. Defined benefit plan assets had the largest decline on record in 2008, and plan liabilities persisted on their skyward trajectory. The recession's downward pressure on interest rates was intensified by governmental intervention. The Federal Reserve not only pinned short-term rates near zero, but also employed unprecedented policies to depress longer-term rates. Quantitative Easing through all three of its phases accomplished the Fed's goal, with longer-term interest rates tumbling to historic depths in April 2013, according to the U.S. Department of the Treasury. These fabricated low rates pushed plan liabilities to unimagined, artificial heights.

Plan sponsors, actuaries, legislators and the public have had very limited success in duplicating the advantages of the DB plan while mitigating or reducing the sponsor's two main objections, the risks of fluctuating contributions and potential unfunded liabilities. Some of the potential solutions have included:

- Cash balance plans, which were concocted by cerebral actuaries as a less costly transition from traditional DB plans. The

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theoretical interest crediting would fluctuate with longer-term interest rates and the lump sum payout would be based on a theoretical account balance both of which reduced the impact of lower interest rates and the latter mitigated longevity risks. Their use by some companies as a guise to wear away lucrative early retirement subsidies and to reduce the inflated value of lump sums was challenged by age discrimination claims. In fact, the AARP believes that cash balance plans are inherently age discriminatory (AARP Public Policy Institute Issue Brief October 2005). This public perception and the low interest crediting, which is usually based on the 30-year T-Note, have steered many large employers away from cash balance plans while most new plans are designed to prefer the management of smaller companies.

- Liability Driven Investing and immunization techniques implement portfolios to align the assets more closely with the liabilities. Plan assets are invested in fixed income correlating with the duration of the liabilities or matching the expected cash flows. This insulates the plan from interest rate fluctuations as the assets and liabilities will move in concert with one another. These practices may be acceptable in a more normal interest rate environment, but in this Fed-influenced, low rate era, the costs can be overwhelming. Even with normal fixed income rates, these techniques eliminate the DB advantage of investing in equities to garner higher returns.
- Purchasing Single Premium Immediate Annuities (SPIAs) for retirees insulates the plan from the investment and mortality risk. Many large companies considered or even executed these purchases over the past year when interest rates were at their lowest. Financially, this seems to be the worst time to buy annuities. With the gain in equities and the recent modest increase in interest rates over the past year, any recent annuity purchases have been proved to be untimely.
- Guaranteed Income for Life products have been structured to turn a portion of the cash flow of a defined contribution plan into a defined benefit. These products are in their infancy and are very complicated. The expenses can be substantial — up to 3% per year for insurance charges associated with the annuity wrapper, mortality risk and the spread. A less costly and more promising insurance product designed to eliminate the longevity risk of outliving a defined contribution balance is a Single Premium Deferred Annuity (SPDA). For example, retirees can use a small portion of their account to buy a SPDA that would pay them (and optionally their spouses) periodically for life, if living, beginning 20-25 years from now. The costs are small since the insurance company's risks are a lot less and payments are deferred well into the future.

THE COMBINED PLAN APPROACH

The combined plan approach — a traditional DB plan and a DC plan working in concert — is good for the sponsor and great for participants. Two plan structures have been used in the past, but have been dealt with independently and have not been operated as complimentary components of a single overall retirement system. Working together, this retirement solution is designed to:

- weight each plan equally with contributions and assets, dividing the investment risk between the sponsor and the participants. This lessens the sponsor's risk and its objections to a sole DB plan.
- redirect a portion of the future contributions from one plan to

the other based upon investment and mortality experience. If the DB plan has unfunded liabilities, a portion or all of the DC plan's future contributions can be redirected to the DB plan without affecting the sponsor's total retirement costs. Partial redirections should happen annually to reinforce the understanding of how these plans work as one system.
- offer flexible payments within the DC plan in retirement to avoid the unnecessary costs of reinvestment or annuity purchases.

Plan Sponsors

The combined plan approach's advantages for the plan sponsor include:

- The sponsor's invest risk is expected to be cut in half because only half of the assets are in the DB plan.
- The sponsor can redirect future contributions to the DB plan from the DC plan in the event of poor investment performance, alleviating the worry of unfunded liabilities.
- The sponsor's contribution requirements remain effectively constant.
- The DB approach delivers higher benefits to longer-term employees for lower overall costs.

Participants

For participants, the combined plan approach's advantages include:

- Participants have a defined benefit lifetime income affording a secure base in retirement and additionally allowing for: (1) a more aggressive investment strategy within their DC accounts, potentially resulting in higher returns and higher probability of not outliving their assets; and (2) more aggressive periodic payments from their DC accounts as the risk of outliving assets is mitigated by the defined benefit lifetime income.
- Participants can better plan for retirement because the two-plan approach lessens the worry about current market conditions at retirement and the worry of outliving a DC account balance.

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Combined Plan Approach in Use Today

The decline in coverage by DB plans continues unabated in corporate America today. However, we have experienced success utilizing the combined plan approach in the multi-employer Taft Hartley and municipal markets.

Multi-employer Taft Hartley plans have used this approach out of necessity. In the late 1990s, because many DB plans were overfunded, "supplemental" DC plans were created. In the 2000s, the defined benefit investment shortages were often defrayed by redirecting future contributions from the DC plan. Generally, each year the plans' trustees recommended contributions to each plan; these recommendations are implemented through collective bargaining.

Some of these DC supplemental plans have grown to provide benefits equal to their DB counterparts, even with the poor investment experience of the lost decade. Others are just now reaping the rewards of the dual plan structure as the DB plans have become fully funded due to the market gains of the last few years and now have substantial excess contribution rates — which will now be redirected to furnish higher benefits from the DC plan. These plans have taught us the advantages of determining the contribution split between the plans each year.

In the municipal plan market, many smaller DB plans were converted to DC plans back in the 1990s, when IRA owners were told they could become millionaires. Now many older participants cannot afford to retire, which has caused problems in the police and firefighters ranks. Defined benefit plans which prefer the older participants are being established to offer some lifetime income to supplement their DC plans. In addition, participants in governmental plans have the ability to make pre-tax ("pick-up") contributions.

In corporate America, it will be difficult to turn the tide in favor of the combined plan approach without having the ability to make DB pre-tax contributions and because PBGC guarantees and premiums are too high. Since these hurdles are much lower in the Taft-Hartley and governmental markets, the combined plan approach can deliver retirement security in a more stable, cost effective program. PC

Keith Kowalczyk, ASA, MSPA, EA, is the president and founder of Ekon Benefits. He has more than 30 years of experience, and serves as frequent author and speaker on industry topics.