Research

The New Wave of Pension Plans in America

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The Evolution of Hybrid Plans

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Plan sponsors and pension consultants have experienced the accelerating move from Defined Benefit plans ("DB") to Defined Contribution ("DC"). Thirty years ago, as DC plans began to proliferate they were shrugged off as an interesting experiment to top up savings for retirement. What started as a minor trend has become an inexorable wave seemingly consigning DB plans to history.

Most in the "DB community" including plan sponsors, consultants and participants maintain that DB provides superior benefits. Their argument is that

needed to provide adequate retirement income. They're right, but many plan sponsors particularly in the private sector have seen little alternative to closing DB plans and shifting the burden to participants, generally through introduction of a DC plan.

Much of the industry and media attention has been focused on why DC plans fail their participants, and even worse, why DC plan participants fail themselves! But it seems accepted as inevitable that DC will become the standard retirement plan structure for future generations of American workers. If that happens, the expertise and experience of the DB plan sponsor community would fade to a footnote in financial history.

But just as DC started as a blip on the DB radar, a new type of "hybrid" pension structure is emerging that we believe will ultimately displace DC as the future standard for retirement plans. Right now it's a minor trend, viewed by many as just an interesting experiment. So far media coverage covers each experimental hybrid plan structure separately, focusing on the trees, not the scope of the potential forest. But if the move to hybrid plans gains real traction, the expertise of the plan sponsor community may need to adapt, but will be in more demand than ever.

This article looks at these new hybrid retirement plan structures that aim to provide adequate benefits while reducing or eliminating the sponsor guarantee of salary-linked lifetime pension. From a participant perspective, some of these structures may not be as attractive as a traditional DB plan. But if sponsors

Hybrid plans offer the features that participants need at a cost that sponsors can bear

can't or won't offer traditional DB any longer, then these hybrids should prove much better than the DC alternative, providing some of the best features of DB and DC:

- Transparency (DC)
- Portability (DC)
- Professional asset management (DB)
- Controlled costs (DB)
- Lifetime income benefits (DB)

If hybrid plans succeed in becoming "industry standard", there are major implications for the whole pension community: participants, plan sponsors and asset managers.

The Present: DC taking over from DB

Like it or not, most individuals in America are now in charge of their own retirement finances. And if they're not in a panic now, they may be when reality hits home and they start to run out of money as they age.

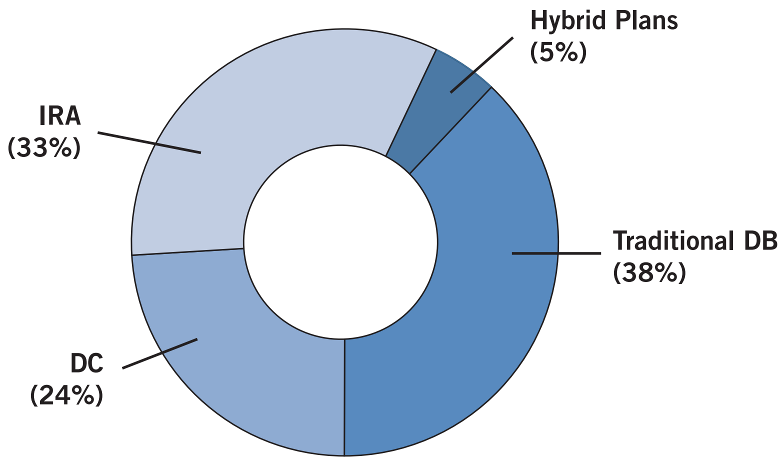
- Most Americans aren't saving anywhere near enough for a comfortable retirement.
- They worry about the risk of a market collapse undermining their savings.
- Low bond yields today suggest future investment returns may be lower than historical averages, especially in fixed income…the asset class of choice for retirees.
- Healthcare costs are spiraling, especially among retirees. Post-retirement healthcare benefits are typically no longer part of the retirement package for most workers and so the cost is likely to be an additional drain on retirement income.
- The longevity question is a big unknown: how long each individual will live? Taking capital out of inadequate savings starts a downward spiral towards running out of assets during the individual's lifetime.

The move from traditional defined benefit pensions to defined contribution savings plans has given Americans the responsibility of managing their retirement savings, a task for which most are woefully unprepared. Imagine the result if we asked retirees to build their retirement homes with their own hands! Today's retirees are faced with a similar task in financial terms. The results will not be pretty.

The Future: Hybrid Plans?

But future generations are not doomed to the same do-it-yourself financial scramble in retirement. As traditional DB plans fade into oblivion, deemed to be a luxury that employers can no longer afford, it's not inevitable that individuals are left to sink or swim on their own. Even though conventional wisdom says that DC is taking over the retirement scene, hybrids are a new breed of pension plan that may be the solution. As a broad category, hybrid plans are much better at meeting the needs of savers and retirees than DC plans, and at the same time are more acceptable to sponsors who can manage the cost and lower their risk much more effectively than in a traditional DB structure.

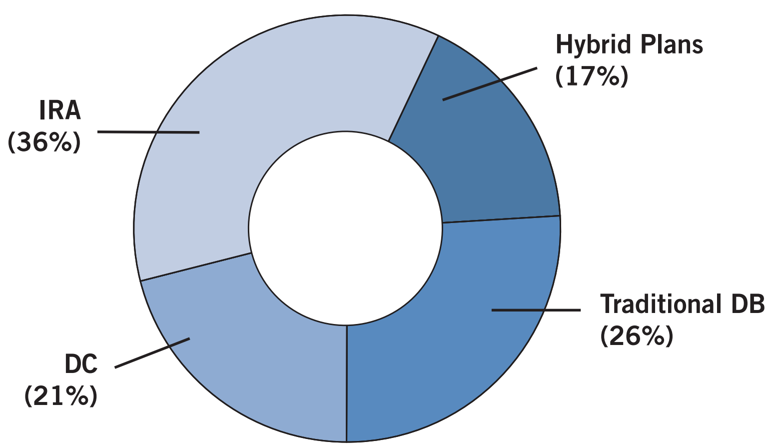
Chart 1
Retirement Assets split 2013



Sources: Federal Reserve Flow of Funds Accounts 1Q 2013; 2012 National Cash Balance Annual Report; Longevity Financial Consulting LLC estimates

Total U.S. retirement assets are estimated at $17.6 trillion as of end March 2013. DC and IRA assets already account for over half the total (57%) with the balance primarily traditional DB plans, both public and private. We estimate only 5% of the total is in hybrid plans now, but the picture may change materially by the end of the decade.

Chart 2
Estimated Retirement Assets split 2020



Sources: Federal Reserve Flow of Funds Accounts 1Q 2013; 2012 National Cash Balance Annual Report; Longevity Financial Consulting LLC estimates

Hybrid plans could triple their share of the total retirement market by 2020, if they do in fact prove more attractive to both sponsors and participants. Initial growth may be at the expense of traditional DB plans, but over time it may be the growth in DC plan assets that will slow and then reverse.

These hybrids include a variety of different designs. To-date, most hybrid plans have been structured legally as modified DB plans but in future, modified DC plan structures may also be used. (When we refer to “DB plans” in this article, we mean traditional DB plans, not those hybrids that happen to be legally structured as DB). Generally hybrid plans have most or all the following features:

- Transparency: participants know the account value of their pension investment
- Portability: that account value may be transferred if the participant moves to another plan
- Professional, centralized asset management: asset allocation and manager/fund selection is handled by money management specialists; participants aren’t burdened with the responsibility of managing their own money
- Controlled expenses: as hybrid plans grow, economies of scale should keep expenses low compared to typical individual DC plans
- Retirement benefit paid as a lifetime annuity: all or part of the retirement benefits are structured as a lifetime income stream, removing the risk of individuals running out of their retirement benefits during their lifetime

The first two of these are characteristic of DC plans, but not DB. The remaining three are typical of DB, but not DC. Some hybrids aim to have them all. So does that mean they’re better than either DB or DC? And if so, will hybrids take over the pension world?

In our view, most hybrid plans are clearly better than DC in terms of the goal of providing adequate retirement benefits. DC plans put the burden of managing retirement investment on the individual. Some people are skilled enough to handle this. The vast majority are not. Behavioral errors compound the lack of investment skills and are likely to result in much lower returns over the long run. The Dalbar studies of investor behavior measure the results of the average US mutual fund investor against the return of the S&P 500 over trailing 20 year periods. The most recent results, for the 20 years ending 2012 are entirely consistent with prior year studies, showing a “behavioral shortfall” of at least 4% a year. By buying high and selling low, the average fund investor had a return of 4.25% annually against the 8.21% S&P return over the 20 years to 2012 according to Dalbar.

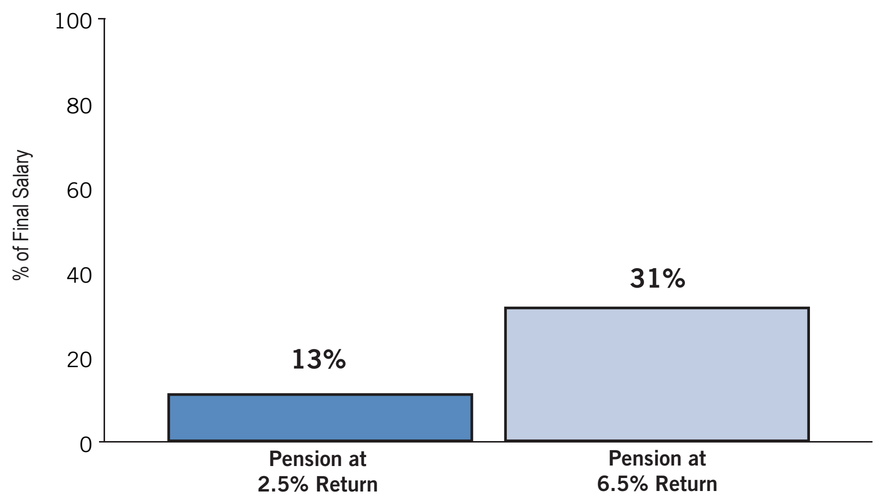
Contribution levels must be high enough to provide a reasonable level of benefits. The math is simple.

If that is representative of how individual investors may fare in their DC pension programs, it has potentially devastating results in terms of eventual retirement income.

Chart 3

DC savings may struggle to provide adequate benefits

Example: For a 25-year-old worker who retires at age 65 with contributions of 5% of salary over a 40-year career, what is the impact of 4% a year shortfall in investment returns due to behavioral or other reasons? Results illustrate % of final salary achieved.



Source: Longevity Financial Consulting LLC
Note: pension income assumption based on immediate annuity rates as of June 2013 on www.immediateannuities.com, example assumes 5% annual contribution rate and 3% annual increase in salary

We assume contributions at 5% of annual income, but as the chart demonstrates, this contribution rate is too low to provide adequate income replacement. Even if annual real returns achieve a respectable 3.5% (6.5% less inflation of 3%), this delivers only 31% of final salary. Factoring in the potential behavioral shortfall and income replacement drops to 13%. Disaster looms.

But it gets worse:

1. The cost of post-retirement healthcare can be substantial. While most traditional DB plans include postretirement health benefits (83% of the DB plans Fortune 100 companies did so according to the 2012 Towers Watson study “Accounting for Defined Benefit Pensions and Other Postretirement Benefits”) the move to DC is gradually limiting the numbers who have this benefit.

2. During working years, “leakage” has become a major drain on participant saving. Leakage includes loans and hardship withdrawals while employed, and cashouts (money withdrawn when leaving an employer that isn’t rolled into another tax-deferred plan). All of these increased after the 2008-9 financial crisis, according to AONHewitt’s 2010 report on DC Leakage (they note that 94% of DC plan sponsors were concerned about excessive loans by participants).

It's not clear that hybrid plans are better than DB for participants. While portability in some of these hybrid plans is a big plus in today's world of frequent job changes, for hybrids all or part of the investment risk is taken by the participant. A traditional DB plan provides a specific benefit related to the participant's income, irrespective of the actual performance of the investments supporting the plan. The key element in a hybrid plan is that the participant's retirement benefit is based on how well the investments have done. And that may have little relationship to income levels during employment. So it's hard to make a case that hybrids are better than DB for a participant. But that's not the choice, because plan sponsors in aggregate have made it clear that they may no longer be providing DB plans as "standard". So the real question is not whether hybrids are better than DB, but if DB is no longer offered, is a hybrid plan an acceptable alternative?

Our answer is yes, but with one critical condition. Contribution levels must be high enough to provide a reasonable level of benefits. This is true for any type of plan, including DB and DC. But for hybrid plans, where the eventual benefits are directly related to investment performance, it's especially true. The math is simple. Benefits at retirement are a function of contributions and the investment return after expenses. What you get out depends on how much is put in, and how well it does. Pension experts estimate that for a typical "middle income" worker, over 15% of annual income should be contributed to a pension plan (including worker and employer contributions) to have a reasonable shot at providing adequate retirement income when combined with Social Security benefits. Experience has shown that most people contribute at lower levels, sometimes much lower. Government estimates measure the median annual contribution by participants in DC plans at around 5%.[1] Either out of necessity or choice, participants struggle to set aside enough to help their future selves a couple of decades down the road.

But if contributions were adequate and assuming that traditional DB is not a realistic possibility for most of today's workers, what are the possible hybrid plan solutions that are now emerging as competitors to DC? Chart 4 summarizes key features; note that these hybrid plans are typically designed legally as variations on the defined benefit structure.

We believe that the coming wave of hybrid plans will not only provide a better retirement for many of today's workers, but will change the face of the pension industry.

This chart includes the original hybrid plan structure, cash balance plans. We have included two new proposed national initiatives (USA Retirement and Secure Choice) that aim to fill the gap for those workers not eligible for any pension benefits. Also included are two new variations on the traditional DB structure that aim to take investment risk off the sponsor and share it with the participants (adjustable and Double DB).

[1] From the Social Security Bulletin (volume 71, no. 2, 2011)

Chart 4

Key Features of Selected Hybrid Plan Structures

	Cash Balance	USA Retirement	NCPERS Secure Choice	Adjustable Plans	Double DB
Status	Exists	Proposed	Early stage implementation	Exists	Proposed
First introduction	1985	2014?	2014	2012	Not yet
Assets est. ($bn)	$900	n/a	n/a	<$5	n/a
Investment risk	Shared	Participant	Shared	Shared	Shared
Sponsor/employer* guarantees plan	Yes	No	Yes	Yes	Yes
Multiple or single sponsor/employer	Single	Multiple	Multiple	Either	Single
Additional legislative approval needed	No	ERISA amendment	ERISA amendment and state-level	No	No
Portability	Yes	Yes	Yes	Limited	Limited
Notional or actual account value	Notional	Actual	Notional	Neither	Neither

Source: Longevity Financial Consulting LLC , August 2013

*sponsor or employer may in some cases transfer the guarantee (e.g. to an insurance company), but a guarantee remains in effect

The first hybrid plans in the U.S. were cash balance plans. These are DB plans that accrue benefits based on a specified annual formula (e.g. a rate of interest). Account balances are transparent to participants and retirement income can be provided by converting the account balance into an annuity at retirement. Importantly, the plan sponsor is still on the hook for any shortfall if the plan assets do not achieve long term performance at least equal to the interest rate or other accrual formula. So the investment risk is shared between sponsor (in case of shortfall against the promised accrual rate) and participant (in case the accrual rate turns out to be much lower than desired over time).

These plans struggled to gain acceptance when introduced by sponsors in the 1980s and 1990s as replacements for traditional DB plans. Participants complained (correctly) that their benefits were being reduced. They argued that this was illegal under pension law. A spate of lawsuits on this point stalled the growth of cash balance plans and led to clarification in the Pension Protection Act of 2006. Cash balance plans are now the fastest growing sector of the pension market, primarily as a way for service businesses like law firms and medical practices to provide top-up pensions for their senior employees and partners.

More recently a few sponsors have introduced so-called adjustable plans, primarily in the private and Taft-Hartley sectors (one such plan sponsor is the New York Times, working with consulting actuarial firm Cheiron, a pioneer of this concept). Adjustable plans are DB plans where eventual benefits vary depending on the performance of the underlying assets during the accumulation phase. Typically they provide a conservative “floor level” benefit, that can be increased over time if assets outperform the liability funding rate. This reduces the risk to the sponsor, and depending on investment results, participants may find their eventual benefits higher or lower than a traditional DB structure. Adjustable plans generally have the DB virtues of centralized investment management, controlled costs and the annuity benefit at retirement. While they may lack the DC attributes of portability and transparency, by accruing benefits based on career earnings rather than the typical DB final salary, there may be little or no penalty cost for frequent job changes. These adjustable plans do not need any legislative approval but each plan needs IRS sign-off.

Another adjustable experimental DB structure designed to make ends meet actuarially is the "DoubleDB" concept floated in 2013 by actuary Edward Friend (www.doubledb.com). DoubleDB eliminates the potential of funding holidays and likewise makes future benefits more dependent on asset performance. As far as we know, no sponsors are using Double DB yet.

Two significant initiatives are underway to tackle the problems of workers with no access to pension plans. At the state level, the National Conference of Public Employee Retirement Systems ("NCPERS") has proposed state level hybrid plans to be run in parallel with existing public sector DB plans so they can take advantage of their existing investment skills. At the federal level, Senator Harkin, chairman of the Senate Health, Education, Labor, and Pensions Committee, is introducing legislation to provide coverage for all workers not eligible for or enrolled in a pension plan. His "USA Retirement Plan" outlines a framework for the private sector to provide universal pension coverage through hybrid plans.

While these various initiatives differ in detail, they each capitalize on key elements of hybrid plans, aiming to combine the best features of DB and DC.

Last but not least, sponsors of both DB and DC plans are seeking ways to modify their existing plans to improve their suitability for both participants and sponsors. For example, DC plan sponsors are now starting to focus on the lifetime income needs of their retiring participant, a longtime DC weakness.

Some DB sponsors have been exploring ways to keep their plans open but shift at least some of the risk to employees. This can be done by varying the contribution levels, retirement age, and benefit features like the level of inflation protection at least for future earned benefits. Within North America, it's Canadian plans that have taken the lead in implementing this concept, under the broad banner of "Shared Risk Pension Plans".

However, because "shifting some risk" effectively means "reducing some benefits" these DB variants have often proved difficult to implement in existing plans. Hard-pressed sponsors still tend towards closing their traditional DB plan as the likely result, and then offering a new plan. Our view is that increasingly over time, these new plans will not be DC, but will be based on hybrid benefit structures.

Under one guise or another, we believe that new hybrid benefit plans will play a major role in the future of the pension industry in the United States. Hybrid plans offer the features that participants need, at a cost that sponsors can bear.

Managing hybrid plans: implications for Plan Sponsors

The emergence of hybrid plans has major implications for how plan assets are invested. Since the inception of DB plans, the key question has been how to fund benefits that are a function of future salaries with assets whose returns are not tied to those salary-based benefits. Under most of these hybrid plan structures, that question largely goes away. Replacing it is the task of investing contributions in a way that those assets can generate adequate retirement income based on the living standards at a future retirement date. Essentially, this is a wealth-generation question: the standard of living at retirement is a function of accumulated wealth over the participant's working life. The goal of investment policy for such hybrid plans must be to match or exceed the growth of that wealth over the long run.

The liabilities of hybrid plans are long term, as are those of traditional DB plans. But unlike those DB plans, there is less need for the sponsor to match fully ("immunize") against promised future cash flows. There are fewer such promises in most hybrid plans. So we believe that investment policy for hybrid plans will have three essential components:

1. A long term time horizon that allows policy to be based on investment, not short-term speculation
2. A focus on generating returns that reflect the growth in participants' wealth over a working lifetime
3. An emphasis on cost control to increase returns

These three components represent a consistent framework, and one that points in a different direction than the Liability-Driven Investing ("LDI") and increasing fixed income focus of the many of the remaining traditional DB plans. In this context, a hybrid plan can divide its asset management approach into two. One segment of the plan's assets can focus on the need to provide the floor, or guaranteed benefit, if any. Here the LDI approach may be relevant, especially if the floor guarantee is set low enough to be consistent with today's low bond yields. In the remaining segment of the plan's assets the emphasis should be on equities and other real assets with an investment approach that focuses on identifying long-term wealth generation opportunities.

Currently in DB plans the goal of maximizing long-term returns at acceptable risk can seem contrary to the goal of minimizing asset-liability mismatches. The first (maximizing returns) promotes an equity-oriented asset allocation, while the second (minimizing asset-liability mismatches) requires a much higher fixed income allocation. In contrast, hybrid plans offer an opportunity to move to a more attainable and straightforward set of investment goals with a consistent focus on long-term returns, risk and costs. This will simplify life for plan sponsors while emphasizing the needs for their expertise in asset strategy, allocation and manager selection.

We believe that the coming wave of hybrid plans will not only provide a better retirement for many of today's workers, but will change the face of the pension industry.

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