

Alternative Retirement Plan Designs

INTRODUCTION

In response to the continuing challenges facing multiemployer pension plans, MCAA asked for a high level assessment of the various alternatives to traditional defined benefit plans that might warrant further consideration. The following general description of these alternative retirement plans is intended to provide an introduction to the characteristics and risk factors of the various plans. Any decisions regarding the adoption and implementation of an alternative retirement plan design must be informed by a thorough analysis by plan professionals, prepared for plan trustees and collective bargaining parties.

Different retirement plan designs provide varying levels of benefit security and contribution predictability; the long term sustainability of retirement plans depends, in large part, on how the various risks are managed through plan design, investment, and funding policies. Chief among the risks to long term sustainability (discussed further below) are the investment risk and what we'll call the "contribution base" risk – a threat to the plan's long term sustainability due to a decline in the plan's contribution base due to declining work levels, worsening demographics, competitive market conditions, or employer withdrawals. In addition, regardless of the design used for future benefits, the underfunding of legacy liabilities under current plans cannot be ignored. This paper provides (1) a brief narrative description of how each plan type works, (2) commentary about the pros and cons of each plan type, including a brief discussion of the applicable risk factors, and (3) a quick reference table of plan characteristics. The plans covered by this summary include traditional defined benefit (DB) plans, variable defined benefit plans, cash balance plans, defined contribution (DC) plans (money purchase and profit sharing), and composite plans.

You may be familiar with the idea that for retirement plans, the contributions plus investment income must be sufficient to cover the cost of benefit payments and operating expenses. The ultimate cost of *any* retirement plan is the sum of all benefits paid plus the expenses to operate the plan, less the investment earnings on the plan's assets. Despite the many apparent differences among retirement plan designs, there are only two conceptual differences: (1) how the investment risk is allocated between the plan sponsor and the participants and (2) how benefits are allocated to participants. However, the different plan designs will be impacted by the various risk factors in different ways and to varying degrees.

For traditional DB plans, absent an adequate funding cushion to absorb adverse experience, or corrective action that may threaten employers' market competitiveness, long term sustainability depends largely on the ability to achieve assumed investment returns and the ability to maintain or increase the number of contributing employers and work levels.

PLAN DESCRIPTIONS

Traditional DB Plan. Provides a fixed monthly benefit upon retirement until death, and a continuing lifetime annuity to the participant's surviving spouse (unless waived). The benefit amount is determined by a formula, typically structured as a percent of contributions or fixed dollar amount per year of service.

Variable DB Plan. Same as a traditional DB plan except that all or part of the benefit is paid as a variable benefit instead of as a fixed benefit. The value of the benefit varies based on how investments perform relative to an assumed investment return, called the "hurdle rate". For example, if the hurdle rate is 5% and the actual return is 7% in a year, then accrued benefits increase by about 2%. There are many variations on the variable concept, such as having the benefit be variable before retirement but fixed after retirement, or adding stabilizing features, including floors or caps, to the annual accruals.

Cash Balance Plan (DB). Similar to traditional DB plans except that the benefit is defined as an account balance, similar to the account balance of a defined contribution plan. The account balance increases each year based on "contribution credits" and "investment credits" defined by the plan (these are "notional" credits, not actual contributions and investment return). Benefits are converted to a lifetime annuity upon retirement, or paid as an optional lump sum, if offered by the plan. One variation of the cash balance plan credits the

actual investment return to the participants' accounts, shifting the investment risk from the plan sponsor to the participants and causing the cash balance plan to operate much like a defined contribution plan.

Money Purchase Plan (DC). Provides participants with individual accounts to which the plan sponsor contributes based on the level set each year in the plan document. Changing the contribution rate requires a plan amendment. Investment earnings accumulate tax deferred until distributed and are then taxed as income, unless rolled over into an Individual Retirement Account (IRA), in which case the taxation is further deferred. Participants may receive their benefit under different forms of payment and there must be a lifetime annuity option (including surviving spouse annuity).

Profit-Sharing Plan (DC). Profit sharing plans are similar to money purchase plans except the plan sponsor has more discretion regarding the timing and amounts contributed to participants' accounts. In addition, while permitted, the lifetime annuity option is not legally required. Note that "profit sharing" is somewhat of a misnomer in that contributions need not be the result of any profits. 401(k) plans are a form of profit sharing plans in which the participants can make their own tax deferred contributions.

Composite Plan. Shares features of both DB and DC plans. Benefits are determined using a formula as in a traditional DB plan, and are paid as a lifetime annuity. However, the benefit is designed so that contributions are projected to maintain 120% funding. Future benefit accruals may be reduced, if necessary to maintain targeted funding levels. Under certain conditions accrued benefits may be reduced to maintain required funding.

COMMENTS ON THE PLAN DESIGNS

This section provides general comments on each of the plan designs, including a brief listing of the various risk factors applicable to each design. The risk factors considered are:

- Investment risk – worse than expected investment returns pose the biggest risk to long-term plan sustainability
- Contribution base risk – if a decline in the contribution base (due to declining work levels, worsening demographics, competitive market conditions, or employer withdrawals) causes an increase in employer cost, the employer's ability to compete in the marketplace may be threatened.

- Employer withdrawal liability risk – the risk of withdrawal liability assessment. There’s also the related risk that financial accounting standards could be changed to require the disclosure of a contingent liability for an employer contributing to underfunded plans.
- Longevity risk – the risk that plan participants live longer than assumed
- PBGC-related risk – the risk that the PBGC increases premiums significantly or becomes insolvent
- Benefit adequacy risk – the risk that the plan’s benefits do not meet participants’ needs, causing them to seek employment elsewhere or to remain employed beyond the age that employers would prefer they retire



RELATED CONTENT

For additional information on the pension system, refer to the Inventory of Construction Industry Pension Plans at <https://www.mcaa.org/?p=10786>.

Traditional DB Plans present the greatest investment and funding risk for plan sponsors. In the multiemployer plan environment, “plan sponsor” means both the contributing employers *and* active participants since the investment risks may be borne by employers as negotiated contribution increases or may be borne in part by participants through wage concessions and/or lower benefit levels. Employer withdrawal liability is a risk to employers and an obstacle to signing new employers. DB plans can provide early retirement incentives and generally provide higher levels of benefits than DC plans for the same level of contributions because DB plan investments have historically outperformed DC plan investments and the cost to annuitize DC plan account balances is greater than the corresponding ongoing DB plan cost. The Pension Benefit Guaranty Corporation (PBGC) provides limited benefit insurance in the event of plan insolvency. PBGC premiums are currently (in 2018) \$28 per participant per year, however, PBGC premiums may increase significantly to address the looming insolvency of the PBGC’s multiemployer insurance program.

***Risk Factors:** The first five risk factors listed above are present for contributing employers in traditional multiemployer DB plans; investment risk, contribution base risk, and PBGC risk affect participants as well as employers. Benefit adequacy is a key risk for participants (as it is in all of the plan designs). Note that the longevity risk is typically a much smaller and more manageable risk than the investment and contribution base risks, since mortality improvements, if they do occur, will happen gradually and predictably. The degree to which any of these risks impacts a particular plan depends heavily on that plan’s funding status – better funded plans or those plans with prudent funding policies are much better positioned to absorb adverse experience without serious consequences.*

Variable Defined Benefit Plans shift the investment and funding risk from the plan sponsor to the participants. Because of this shift in investment risk, variable DB plans often face resistance from unions and participants. The shift in risk can be mitigated by implementing alternative provisions that protect participants, such as (1) a minimum guaranteed benefit, (2) providing a portion of the benefit as a fixed (traditional DB) benefit, (3) variable benefit prior to retirement but fixed benefit at retirement, or (4) offering a choice at retirement (fixed or variable). A pure variable DB plan essentially eliminates any withdrawal liability with respect to future accruals, but the withdrawal liability risk attributable to the legacy (pre-variable) liability remains (even for new employers). In all other respects, variable DB plans function the same as traditional defined benefit plans, including the payment of PBGC premiums.

Risk Factors: The pure variable plan eliminates the investment risk for employers since losses are borne by participants. The contribution base risk is effectively eliminated, unless the contribution base shrinks so much that operating expenses alone become a financial burden. Employer withdrawal liability risk is also eliminated, except in the case of mass withdrawal where all, or virtually all, of a plan's employers withdraw. Unanticipated longevity improvements present a small risk that unfunded liabilities could develop. The risk of higher PBGC premiums remains. To the extent that any benefit protections are provided for participants, such as a minimum guaranteed benefit, some of the risk shifts back from the participant to the plan sponsor.

Cash Balance Defined Benefit Plans have rarely been implemented in the multiemployer arena, probably because they retain essentially the same investment and funding risks for the plan sponsor as traditional DB plans, but appear more like DC plans to the participants. Cash balance plans are subject to the same rules as traditional DB plans, including withdrawal liability and PBGC premiums. The cash balance plan investment risk can be shifted to the participants by crediting actual or indexed investment returns instead of fixed interest credits, in which case the cash balance plan operates more like a DC plan, though all the DB plan rules would still apply. As with the variable DB approach, to the extent that participant benefits are protected by guarantees (e.g., no less than a 0% return), the funding risk shifts back to the plan sponsor.

Risk Factors: Unless the investment risk is shifted to the participant, the risks under a cash balance plan are no different than those under a traditional DB plan. Given that cash balance plans typically offer lump sum distributions to participants, cash balance plan sponsors generally bear less longevity risk than under traditional DB plans and the sponsor's investment risk ends at the point of distribution, when both of these risks are transferred to the participant.

DC Plans (both money purchase and profit sharing) place the investment risk entirely on the participant; the employer's obligation is limited to the agreed upon contributions. DC plan benefit accrual patterns favor younger participants because they have more years for investment earnings to accumulate than do older participants. Early retirement incentives and other ancillary benefits cannot be provided in DC plans. There is no employer withdrawal liability and no PBGC insurance or premiums. In practice, these plans generally do not function as retirement plans because account balances are often used for non-retirement purposes when participants leave covered employment. Further, converting lump sum account balances to lifetime income is challenging for participants and can be expensive – annuities offered by insurance companies are priced at low interest rates (because they are backed by fixed income investments); self-annuitizing presents both an investment risk to participants and the risk that participants will outlive their retirement funds.

Risk Factors: None of the risks associated with traditional DB plans are present for employers in DC plans, except possibly the benefit adequacy risk to the extent it adversely impacts employee retention and retirement; participants bear all of the investment, benefit adequacy, and longevity risk. The benefit adequacy risk for participants is greater in DC plans than in DB plans, because of DC plan financial inefficiencies (typically lower returns and higher annuitization costs than DB plans). The benefit adequacy risk in a DC plan can be partially addressed by restricting access to DC accounts until the participant has retired.

Composite Plans have not yet been sanctioned by enabling legislation. If and when that legislation is passed, composite plans will offer both predictable lifetime retirement income for participants and significantly less funding risk for sponsors than traditional DB plans. The investment and funding risk will

be shared between the plan sponsor and the participants, with participants bearing a relatively greater share of the risk because benefits may be adjusted if necessary to maintain funding targets. The relatively lower funding risk for plan sponsors follows from the required 120% funding; traditional DB plans rarely aim for or attain 120% funding.

However, the 120% funding requirement means that either contributions must be increased to maintain the current benefit accrual or benefit accruals need to be reduced to be supported by current contributions. Despite the security and stability offered by the composite plan, there may be an increased risk to the legacy plan's funding because the minimum funding requirements for the legacy plan may be reduced when a composite plan is adopted – if adequate funding cushions for the legacy plan are not maintained, the composite plan may not provide the hoped for funding stability of the combined legacy/composite plan. Composite plans will have no employer withdrawal liability and no PBGC coverage or premiums. Absent enabling legislation, the composite plan concept can be adapted to the traditional DB plan model, except for the ability to reduce accrued benefits.



RELATED CONTENT

For the latest information about proposed pension reform, see <https://saveourfutures.com>.

For more in-depth information on the pension reform concept, see the Groom Law Group paper on the topic at <https://www.dropbox.com/s/9307uuvqcfr47x4/Composite%20Plan%20White%20Paper.pdf>.

Risk Factors: Composite plans reduce, but do not completely eliminate, the investment and contribution base risks for employers. The employer withdrawal liability and PBGC risks are eliminated. The longevity risk is the same as under the traditional DB plan.

CONVERTING TO AN ALTERNATIVE DESIGN

- Deciding on an alternative design requires a thorough evaluation of the relevant risks, including, but not limited to: (1) investment risk, (2) funding risk, (3) income adequacy, (4) impact on the workforce, and (5) acceptance by participants. This evaluation necessarily involves the current plan's actuary, investment consultant, and legal counsel working together to identify the trustees' and bargaining parties' objectives and then to develop the optimal plan design.
- Traditional DB plans can be converted to another type of DB plan (variable DB, cash balance, or composite) in one of two ways: (1) amend the current plan to freeze accrued benefits, with future benefit accruals earned under the new plan design or (2) freeze the current plan and set up a second plan for the new design. Converting a traditional DB plan to a DC plan can be accomplished only by freezing the DB plan and setting up a separate DC plan.

- For most, but not all, construction industry DB plans, contributions are the responsibility of the bargaining parties (settlor function), while benefits are controlled by the plan's trustees (fiduciary function). This suggests that the decision to change to an alternative benefit design would fall to the trustees. However, this is not necessarily the case – each situation is different and the authority to change the plan design will be governed by the relevant documents: collective bargaining agreements and the DB plan's trust agreement and plan document. Similarly, the manner in which a plan design dispute will be resolved will vary from case to case. The interested parties should work with legal counsel to know where the authority for change rests before proceeding with an alternative plan design study.

ADDITIONAL COMMENTS

- In general, construction industry employers are exempt from withdrawal liability unless they continue to perform non-union work. While this protects many withdrawing employers, it exacerbates the contribution base risk for the remaining employers who must fund benefits attributable to work performed for other employers.
- Worsening demographics (decreasing ratio of active participants to inactive participants) puts additional pressure on contribution rates. When losses occur, funding for those losses may be spread over a declining contribution base (work units, such as hours) meaning that the required contributions for each hour must increase more than if the work levels were stable or growing.
- To date, PBGC premiums have not been a significant expense for most construction industry DB plans. However, that could change if legislation is enacted to significantly increase PBGC premiums to address the PBGC's projected insolvency.
- The view that accrued benefits under a traditional DB plan can never be reduced is true only to the extent that the plan remains solvent (note that accrued early retirement subsidies may be reduced by a plan in critical status). In the event of pending insolvency, benefits may be reduced dramatically; even more so if the PBGC itself becomes insolvent and no legislation is enacted to save the PBGC's multiemployer program or the benefits of insolvent plans.
- If composite plan legislation is enacted, the decision to implement a composite plan may be a bargaining decision or a trustee decision, depending on the circumstances.

- The current financial statement disclosure rules for employers contributing to multiemployer DB plans are fairly simple, thanks to the FASB’s simplified reporting standard adopted in 2011. Essentially, employers are required to disclose only the names of the plans to which they contribute, the amounts contributed, the “zone status” of each plan, and whether the plan has adopted a funding improvement plan or rehabilitation plan (if the plan is certified in endangered or critical status under the Pension Protection Act). However, there is always the threat that the FASB will reconsider the issue and adopt onerous financial disclosure requirements that could pose a significant market competitiveness threat to employers in underfunded multiemployer DB plans.
- It can take many years for the change to a new plan design to have a significant impact on plan funding. For example, 15 years after changing to a new plan design, it is likely that 75% or more of the total benefit liability will be attributable to benefits earned before the plan change that was implemented 15 years earlier.

The following **Exhibit** provides a snapshot comparison of the key characteristics of the plan designs discussed above.

Alternative Plan Designs: Characteristics

| Benefit Defined By | Traditional DB | Pure Variable DB ¹ | Cash Balance DB ² | Money Purchase DC | Profit Sharing DC | Composite Plan ³ |
|------------------------------------|----------------|-------------------------------|------------------------------|-------------------|-------------------|-----------------------------|
| | Formula | Formula | Account Balance | Account Balance | Account Balance | Formula |
| Stable Costs | No | Yes | No | Yes | Yes | Yes |
| Professional Investment Management | Yes | Yes | Yes | No ⁴ | No ⁴ | Yes |
| Sponsor Bears Investment Risk | Yes | No | Yes | No | No | Limited |
| Benefit Payable for Life | Yes | Yes | Yes | Yes ⁵ | No | Yes |
| Accrued Benefit Never Decreases | Yes | No | Yes | No | No | No |
| PBGC Guarantee | Yes | Yes | Yes | No | No | No |
| PBGC Premiums | Yes | Yes | Yes | No | No | No |
| Withdrawal Liability | Yes | Negligible ⁶ | Yes | No | No | No |
| Participant Loans | No | No | No | Permitted | Permitted | No |
| Pooled Longevity Risk ⁷ | Yes | Yes | Yes | No | No | Yes |
| Inflation Protection | No | Yes | No | Yes | Yes | No |
| Surviving Spouse Benefit | Yes | Yes | Yes | Yes ⁵ | No | Yes |
| Ancillary Benefits ⁸ | Yes | Yes | Yes | No | No | Yes |
| Hardship Distributions | No | No | No | Yes | Yes | No |

Notes:

- 1 Responses may differ for different approaches to the variable approach, such as fixed benefit at retirement or floor benefit.
- 2 Responses apply to fixed or indexed investment credit; responses will differ if actual investment return is credited to cash balance account.
- 3 Responses are based on understanding of currently proposed composite plan rules; stable cost noted above can be threatened by significantly adverse investment experience.
- 4 DC plans typically have participant directed investments, but plan sponsor can use professional investment management instead.
- 5 Typically not paid as lifetime benefits, but plan must offer ability to purchase annuity from insurance company.
- 6 Withdrawal liability is essentially zero for the pure variable portion of a plan, but would still apply to the legacy traditional DB portion.
- 7 Pooling of longevity risk means that the plan provides lifetime benefits, as opposed to each participant being responsible for matching benefits to life expectancy.
- 8 Ancillary benefits are benefits other than retirement benefits, such as disability and death benefits.

The Yes/No responses noted above are not absolutes in all cases, but may indicate the general tendency for the characteristic. All responses assume that the plans remain solvent indefinitely.

Acknowledgements

Prepared by Cary Franklin and Jonathan Feldman of Horizon Actuarial Services, LLC, a leading consulting firm that specializes in providing innovative actuarial solutions to multiemployer benefit plans. Horizon serves over 120 pension and health and welfare plans in various industries, including construction.