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Longevity Plans: An Answer to the Decline of the Defined Benefit Plan

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With people living longer and the undeniable shift from defined benefit plans to defined contribution plans in the private sector, is it really a surprise that retirement income concerns have risen to the forefront? Defined contribution plans, initially devised as a supplementary retirement savings vehicle, have essentially replaced defined benefit plans as the primary employer-sponsored retirement plan. The problem with just having benefits from a defined contribution plan as a primary retirement source is that participants take on longevity risk. This creates challenging circumstances for people to properly manage their investments and withdrawals from their retirement accounts.

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> It is well known that having a defined benefit plan offering a life annuity benefit can combat participant longevity risk. But defined benefit plans have lost favor with many employers, which is due to their cost and cost volatility. While many employers recognize the retirement planning merits of defined benefit systems, many defined benefit plans have been frozen and replaced because of sustainability concerns. Thus, the question is this: Can an employer-supported retirement model be designed to sufficiently address both participant longevity risk and employer sustainability concerns?

Consider a supplementary defined benefit plan with the following features:

- Unit accrual pattern: No cost leveraging from final average salary designs.
- Later benefit accruals: Plan participation would not begin before age 45.
- Later benefit commencement: No earlier than age 75.
- Life annuity options only: Single life option for single participants and 75 percent joint and survivor option for married participants.

The plan structure described above forms the basis for a longevity plan.[1] The first two features address employer cost and volatility concerns. The features in the last two bullets address longevity risk.

The concept of having a defined benefit plan with unit accruals directly addresses employer cost and cost volatility concerns. Traditional final average pay plans should not be considered given their benefits-leveraging features. Only unit accrual type plans should be proposed. The idea here is that you want to have a plan that bases benefits either over a person's career average earnings or over a person's service career. Final average pay plans can be manipulated to reflect increased earnings in a person's final years of employment. Furthermore, because past service benefits are leveraged higher upon future pay or service increments, these types of plans end up being very costly compared to the unit accrual plan alternative.

Cost volatility concerns are more easily addressed within a unit accrual plan. Generally, these plans can take on conservative investment approaches because they do not have benefits-leveraging features or built-in salary inflation. Interest rate risk can be virtually eliminated by using liability-driven investment strategies. As a plan portfolio's fixed income holdings increase relative to equity investments, however, the plan's expected rate of return can experience a drag. Those plan sponsors that want to stay invested in equities while still reducing market risk can consider tail risk hedging investment strategies. Coupling a low-cost design with the appropriate investment strategy can help to greatly lessen cost volatility and make plan funding more predictable. It is also important to mention a positive investment aspect of the proposed retirement paradigm for the plan participant. Because a retiree is receiving a guaranteed employer-funded benefit from the longevity defined benefit plan, that person can adjust investment strategy with respect to benefits accruing from the defined contribution plan. This allows participants with a higher risk tolerance to invest more aggressively in their individual savings accounts.

Delaying participation to no earlier than age 45 also would help to keep the employer cost of a longevity plan low and manageable in relation to other retirement benefit options. A person working until age 65 would now have only 20 years of benefit accruals rather than 40-plus years. Effectively, the defined benefit would have a service cap but would reflect the higher pays that would presumably be present in a participant's latter years of employment.

Delaying benefit commencement to no earlier than age 75 further serves to keep employer costs down while also addressing longevity risk concerns. The benefit would be paid out over a shorter life span; this would greatly reduce the cost of the plan relative to a plan with an age 65 or earlier benefit commencement feature. Paying the benefit out at a later age also allows for a longer period of asset buildup. This feature underscores the notion that the startup costs of a longevity plan would be relatively modest. Moreover, a defined benefit plan commencing at a later age such as 75 would perhaps be the most useful to retirees. Having presumably used a good portion of their present retirement savings (defined contribution and personal savings accounts), their defined benefit plan would now commence at the most critical of times and provide income for the rest of their lives.

COST EXAMPLE 2-PERCENT-OF-PAY CAREER AVERAGE PAY PLAN

Let's take a look at a cost example of a 2-percent-of-pay career average plan for a participant hired at age 45 and terminating at age 65. We'll further assume a starting salary of $60,000 and a 2.5 percent salary scale. This would result in a salary of roughly $106,500 just prior to termination.

The participant's life annuity benefit commencing at age 75 would be about $31,000 per year. If the participant's benefit were to be funded over that person's working career of 20 years, the annual employer cost to fund this benefit would be about 1.8 percent of pay. By comparison, if the participant's retirement benefit were to commence at age

65 under current Internal Revenue Service rules, the annual employer cost to fund this benefit would be about 2.5 percent of pay.

Thus, by limiting benefit eligibility until age 45 and by not allowing benefits to commence earlier than age 75, the cost of this plan would be relatively low to fund. Using this same example, while extending benefits commencement to age 80, the employer's cost would be significantly lower at about 1.5 percent of pay.

Having a longevity plan with a simplistic design in which only life annuities can be offered directly addresses the issue of longevity risk. We've heard many plan sponsors cite a lack of appreciation and understanding among their employees when it comes to defined benefit plans but the concept of a retiree having a life annuity and never running out of money is both a pleasing and basic truth. Aside from single life annuities and 75 percent joint and survivor options for married participants, no other types of benefits would be allowed. Lump-sum amounts will presumably be available via a retiree's defined contribution plan and personal savings.

Collecting an annuity benefit from the supplementary defined benefit plan would not preclude a retiree receiving a lump-sum benefit from the defined contribution plan. It would just make it easier for the retiree to make decisions on how best to manage his or her lump-sum benefit from a withdrawal and consumption perspective; the participant would know exactly when his lifetime annuity benefit would start, no earlier than age 75 in our proposed plan. Early retirement would be restricted from the proposed longevity plan because the concern is for the latter years of retirement and the understanding is that other sources of savings should be enough to get retirees through the initial years of retirement.

LEGAL BARRIERS

Having reviewed the ideal features of a longevity plan, it is important to understand the legal barriers preventing its current existence:

- Minimum eligibility rules[2]
- Normal retirement date definition[3]
- Minimum distribution rules[4]

In order to maintain a tax-qualified defined benefit plan, Internal Revenue Service (IRS) rules require employees covered by a defined benefit plan to be eligible for participation no later than age 21 after completion of one year of service. This rule made sense when defined benefit plans were a prevalent employer-sponsored program. A longevity plan deliberately delays participation from the perspective of cost control and because of the recognition that it will function as a supplemental retirement option. Starting benefit accruals at a later age, such as 45, as in the proposed longevity plan, also would cut down on administration and recordkeeping costs for employers.

IRS rules also specify the permitted definition of normal retirement age. Essentially, this age cannot be pushed beyond the later of age 65 or completion of five years of service. Allowing for the deferral of benefit commencement another 10 years to age 75, as in the proposed longevity plan, creates a huge impact on the employer's cost to fund such a benefit. It would be expected that an average retiree would have enough short-term funds to last during the initial years of retirement. The longevity plan addresses the issue of retirement destitution during the later years of life, beyond average life expectancy.

A defined benefit plan allows several tax advantages[5] for the sponsoring employer and retirement plan participant. But eventually the federal government wants to recapture some of this lost tax revenue when retired participants commence benefits. Thus, IRS rules require that retirement benefits must be commenced by the April 1 following the later of the year of termination or the year in which a participant attains age 70.5. This essentially means that any participant terminating with a vested benefit at any age before attaining 70.5 is required to commence benefits by the April 1 following age 70.5. If retirees do not commence benefits in accordance with this rule, they are subject to federal excise taxes. This rule would clearly conflict with the proposed longevity plan, which does not allow benefits to commence until age 75.

ANNUITIES: NOT A PANACEA

Longevity risk must be both appreciated and balanced between employer and employee. This may involve a reworking of the perception of retirement. There has to be a renewed and genuine appreciation of retirement benefits for retirees from the general public. There has to be an understanding of the risks at stake in exhausting one's retirement funds too early. There has to be both an appreciation and understanding of the employer's ability and desire to fund benefits for its retired workers so that they can survive in their retired years with dignity. Retirement is too often a back-burner topic, and one does not fully comprehend what it means to be retired until it happens one day.

It is worth noting that there have been some other proposed lifetime income solutions besides the creation of longevity defined benefit plans. However, many of the solutions that have been proposed to deal with longevity risk haven't really fared that well. For example, one might decide to purchase an annuity from an insurance company to combat longevity risk. But purchasing annuities from insurance companies generally comes at a high cost. Also, people have to get over the psychological hurdle of laying out cash savings to purchase an annuity, knowing in the back of their minds there is a chance they may not survive long enough to make it a worthwhile investment. It is well known that annuities are most efficiently provided and priced through a defined benefit plan. This notion leads us to consider Revenue Ruling 2012-4 that allows for defined contribution transfers into a defined benefit plan for purposes of annuitizing benefits.

The need for lifetime income streams is obviously a serious concern for the federal government; however, what sounds good on paper does not necessarily translate to success in practice. One problem with the proposed revenue ruling is that uniform mortality assumptions are required for annuity conversions. This will have the effect of discriminating against males and discriminating in favor of females. The fact that females generally outlive males will be ignored by the mandated uniformity assumptions. A second problem with the proposal is anti-selection. Those with health problems will avoid annuity conversion. Given these and other potential issues, one would have to wonder why defined benefit plan sponsors would want to allow defined contribution rollovers into their plans; it would make the defined benefit annuity more costly and less efficient to provide.

CONCLUSION

The combined retirement income from Social Security, a defined contribution plan, and a supplementary defined benefit longevity plan can mark the second coming of the three-legged stool concept—a concept that has much wisdom and has been around for ages. Originally, it was the defined benefit retirement plan, Social Security, and personal savings that made up the three-legged stool. With the shift from defined benefit to defined contribution plans—specifically 401(k) plans—the stool can hardly stand at this point as the potential for personal savings has greatly dwindled. In fact, many must choose between growing their personal savings and contributing toward their retirements through defined contribution plans.

If retirees cannot adequately support themselves, they will need to appeal to forms of social welfare that are funded by the federal government. Thus, the question is not *whether* but *when* federal regulations will allow for this conceptual idea to become a reality. The need for lifetime income through longevity plans is obvious, especially with the onset of Baby Boomer retirements.

NOTES

1. As an aside, it should be noted that a longevity plan with the features proposed in this article is only hypothetical in nature. Internal Revenue Code (IRC) rules do not currently allow such a plan design to be operable; however, it is the hope that one day, this type of design will be legalized as it will specifically address participant longevity and employer cost concerns.

2. *See* IRC § 401(a)26.

3. *See* IRC § 411.

4. *See* IRC § 401(a)9.

5. *See* IRC § 404.

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