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What is Required to Improve Retirement Income Security?

By Paul J. Donahue[1]

There is widespread agreement among actuaries, economists and pension regulators that promotion of lifetime income is the single most critical element of improving retirement security. According to the American Academy of Actuaries:

> In today's aging society, the widespread assurance of lifetime income is the single most important step needed to improve the retirement security of older Americans. The American Academy of Actuaries believes that retirement security can and should be significantly improved by the promotion of lifetime income, and that actuaries have an important role to play. The Academy has identified lifetime income as a top public policy issue and strongly supports initiatives that will lead to more widespread use of lifetime income options.[2]

This essay sets out views on the economic realities from an employer's perspective[3] underlying employer-based benefits and identifies three regulatory reforms critical to increasing the take-up of lifetime income in employer-based benefit plans. Without these reforms, there is no clear path to statistically significant increase in the take-up of lifetime income. As necessary as these regulatory reforms are, more plan sponsor and participant education will also be needed.

THE ECONOMIC FOUNDATION: EMPLOYERS SEEK MAXIMUM BANG FOR THEIR BENEFIT BUCKS

To remain competitive in the global economy, "it is imperative that companies find ways to control labor costs."[4] A primary reason labor costs have been increasing rapidly is the rising cost of benefits.[5] Cornell ILR School professor Kevin Hallock "suggests employers can optimize the salary/benefits formula by thinking carefully about how much benefits are worth to specific workers, versus how much they actually cost."[6]

Regulatory reforms are critical to increasing the use of lifetime income in DC plans.

Exhibit I.
Comparison of employee costs to employee valuation[7]

Benefit	Estimated employer cost to provide specified benefits as a percentage of payroll[8]	Percentage of employees considering benefit extremely or very important[9]
Health insurance	12.8%[10]	86%
Life insurance	.3%	43%
Disability insurance	.45%	44%
Defined benefit pension	10%	50%
Defined contribution pension	4.5%	75%

As Exhibit I shows, a dollar spent on a defined benefit plan benefit is not cost-effective as an employee recruitment and retention tool compared to other benefits.[11] Almost as many employees view life and disability insurance as important as a defined benefit plan, though life and disability insurance each cost the employer less than 5 percent of the cost of a defined benefit plan. Additionally, 25 percent more employees consider a defined contribution plan important as consider a defined benefit plan important, though the DC plan costs the employer less than half as much as a defined benefit plan.

THE RETREAT OF THE DEFINED BENEFIT PLAN[12] IS IRREVOCABLE, DRIVEN BY FUNDAMENTAL ECONOMICS

If participants understood the value of a deferred annuity benefit, they would be electing annuities where available as distribution options in defined contribution plans.[13] This would likely be the case even if there were no regulatory or administrative costs in addition to the cost of the benefit itself. Further, the long-term nature of a defined benefit plan and the absence of fiduciary safe harbors mean there is an additional risk of litigation expenses and damages arising from participant allegations that the plan sponsor has breached its fiduciary duty.

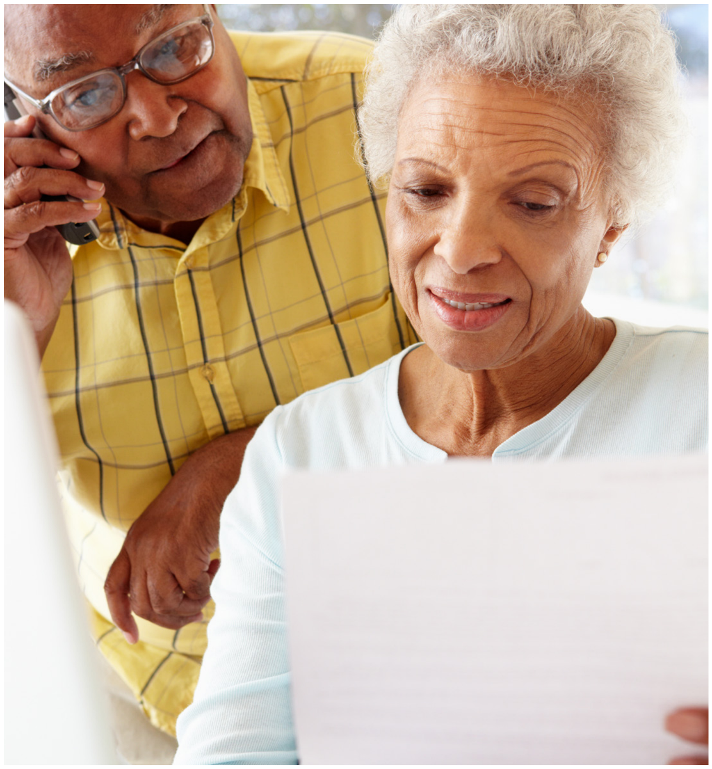
BALANCE SHEET EFFECTS EXACERBATE THE CURRENT COST PROBLEM

In an attempt to control costs, employers moved decades ago away from the actual purchase of deferred annuity segments as the primary funding vehicle for defined benefit plans. In the first stage of this movement away from funding plan benefits as accrued through annuity purchases, plan sponsors kept plan assets in a trust during an employee's working life and purchased annuities at retirement. The next step was to retain all plan assets and liabilities, with no risk transfers to insurers. The Financial Accounting Standards Board's FASB 158 required publicly traded companies to put the funding status of their pension plans on their balance sheets and to recognize certain pension costs as a component of other comprehensive income.[14] This greatly increased the prominence of unfunded pension liabilities considered by market analysts to be too large compared to the size of the business enterprise.[15] The termination or freezing of defined benefit plans and the transfer of balance sheet assets and liabilities to insurers is a completely rational response to the employee valuation and balance sheet issues.

PLAN SPONSORS WILL NOT VOLUNTARILY ASSUME FIDUCIARY EXPOSURE

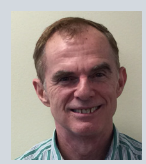
Fiduciary exposure is a deferred cost with no current or future benefit. As discussed above, employers need value for their benefit costs to remain competitive in the labor market. As Exhibit 1 shows, defined contribution plans are exceptionally attractive from a cost/benefit perspective. More than 75 percent of employees view a defined contribution plan as important, not far behind health insurance, though the defined contribution costs the employer less than half as much as health insurance.[16]

To increase provision of employment-based lifetime income, significant regulatory changes are required. A plausible case could be made, given the unique characteristics of an annuity investment, that the existing 404(c) regulations require a plan sponsor offer lifetime income as a plan option.[17] In any case, the regulations should be revised to require that DC plans relying on the safe harbor offer lifetime income. There is surely as much justification for such a requirements as for the existing requirement to provide a low-risk, liquid, income-producing fund.[18] Even with such a requirement, but more important without it, there should also be an issuer safe harbor that would enable an issuer of lifetime income annuities to assure an employer that the issuer fell within a safe harbor. It is my view that even a safe harbor which required the employer determine issuer compliance is not enough, in the absence of a requirement that a plan provide a lifetime income option.



Further, Exhibit I and the election experience of the relatively few defined contribution plans that offer lifetime income show employees simply do not appreciate the economic value of annuities.[19] To meaningfully increase provision of lifetime income, plan sponsors will need to have the ability, without incurring additional fiduciary exposure, to allocate irrevocably some or all of the employer match to lifetime income. This would require modification of the 404(c) safe harbor regulation.[20]

Employers rationally do not wish to increase benefit costs in a way that gets no employee credit. Within the last several months, there have been two settlements of employee class action defined contribution plan suits that totaled $92 million.[21] Results like these are not only meaningful financially, but they partially negate, in terms of negative employee perceptions, the value of the benefit plans. The cases are ample evidence of why employers have no appetite whatever for additional fiduciary exposure, regardless of the social utility of taking that risk. For that reason, the two regulatory reforms I propose are essential to enhancing the role of employer-based lifetime income in ensuring the retirement income security of Americans. ■



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ENDNOTES

[1] I am grateful to Anna Rappaport, Anna Rappaport Consulting, and Nan Tecotzky, vice president, MetLife, for comments on earlier drafts.

[2] See also the Society of Actuaries' fact sheet "Reaching Guaranteed Lifetime Income: Tackling Nine Misconceptions"; "Lifetime Income—An Important Focus of Retirement Planning" by Anna Rappaport; and "Lifetime Income Insurance Products and Emerging Issues" from the American Academy of Actuaries.

[3] I do not address social utility of various benefits in my analysis of employer benefit economics. I share the academic consensus that increasing provision of lifetime income is in the national interest, but I do not expect employers to take on an added economic burden imposed by perversely structured benefit incentives because they are socially useful.

[4] "Employee Compensation," Encyclopedia of Management.

[5] Ibid.

[6] "Employee Compensation: Know the True Costs of Employment and Optimize Them to Benefit Employers, Employees," from the Center for Advanced Human Resource Studies.

[7] I wish to emphasize at the outset that this table says nothing about the economic cost/benefit of the benefits listed, nor anything about the relative social utility of the benefits. Further, the data represent averages, presumably for employers who provide, on a normalized basis, all the benefits, and there would be wide dispersion around these numbers for particular employers. Obviously, not all employers provide these benefits.

[8] These are approximations based on data from the Bureau of Labor Statistics' "Employer Costs for Employee Compensation," Table 6, private sector, goods producing and all services, and "Retirement Costs for Defined Benefit Plans Higher Than for Defined Contribution Plans." In the case of health care, see the following note. While I have no doubt the percentages vary materially from what we could calculate with actual compensation figures for employers offering particular benefits, I believe the numbers are good enough to support the arguments I make based on them.

[9] "Views on the Value of Voluntary Workplace Benefits: Findings from the 2014 Health and Voluntary Workplace Benefits Survey," in *EBRI Notes*, p. 4.

[10] *See* The Kaiser Family Foundation's "Snapshot: Employer Health Insurance Costs and Worker Compensation." This is a number for 2010, but I have not projected.

[11] Employees with significant service still accruing service credit in a defined benefit plan are an exception to this generalization. The plan significantly promotes the retention of these employees. However, these are also the accruals most costly for the employer.

[12] I exclude from consideration cash balance plans, which I intend to discuss further in a subsequent essay. I believe that with some relatively modest legislative changes, there could be a greater role for simplified cash balance plans.

[13] http://www.americanbar.org/content/newsletter/groups/labor_law/ebc_newsletter/12_spring_ebc_news/12_spring_aball_ebc_choose.html

[14] *See* Financial Accounting Standards Board's FASB 158.

[15] *See* GM Chief Financial Officer Chris Liddell in Craig Trudell, "GM Puts $2.32 Billion of Stock Toward Funding Pensions," *Bloomberg Business*, Jan. 14, 2011: "You can't have this huge tail wagging the small dog. You can't be a $100 billion pension plan with a car company attached to it. The value of the company should be driven by the quality of the vehicles and the margins we make on them, not [by] what the discount rate is."

[16] Problems evaluating deferral lead participants to undervalue defined benefit plans and to overvalue defined contribution plans. Even in the absence of a match, for each dollar of DC contribution, an employee sees take-home pay go down $.7 and an investment account increase $1. The employee perceives an immediate gain of $.3, since the employee is ignoring future taxes. In a DB plan, the amount of the employer contribution is not visible in the paycheck, the participant is not calculating pay period to pay period benefit accumulations, and even if the employee did do that, the present value of the future benefit would not feel like an immediate increase in wealth. Employers who wish to retain DB plans could greatly increase their value as a retention and recruitment tool by including in pay statements information on benefit accrued and their present value.

[17] 29 CFR § 2550.404c-1(b)(3)(i)(B)(3) requires that the available alternatives "enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary." I believe a plan without a lifetime income alternative cannot meet this requirement with respect to participants nearing retirement.

[18] Cf. 29 CFR § 2550.404c-1(b)(2)(C)(2)(ii).

[19] *See* "Towers Watson CEO: Trends Don't Favor Lifetime Income Adoption." According to John Haley, chief executive officer of Towers Watson, only 12 percent of DC plan sponsors offer a lifetime income distribution option, and among the plans that do offer them, the vast majority of plan sponsors report a take-up rate of 5 percent or less.

[20] *See* Jody Strakosch and Melissa Kahn, "Better Outcomes from Defined-Contribution Plans," *The Journal of Retirement*, vol. 2, no. 3 (winter 2015). This excellent article explores a settlor path to allocation of some portion of employer match to lifetime income, and discusses issues of administration. However, I believe it recognizes, in part explicitly, in part implicitly, the need for regulatory relief from fiduciary risk exposure.

[21] *See* "Lockheed Martin to pay $62 mln to settle 401(k) lawsuit" and "Ameriprise Financial Settles ERISA Fee Litigation."