Blue Sky Retirement Ideas

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Blue Sky Ideas and Retirement Policy

Eric A. Keener
American Academy of Actuaries Retirement System Assessment and Policy (RSAP) Committee

• In 2017, the Academy established the RSAP Committee to:
  • Develop and maintain a framework for the assessment of retirement systems and policies in the U.S. and elsewhere
  • Evaluate alternative retirement system designs with respect to the framework
  • Comment on current or proposed retirement system policies, including how they support, enhance or contradict identified key principles

• RSAP evolved from the Academy’s Forward-Thinking Task Force, created in 2010 to:
  • Build on ideas from the SOA’s Retirement 20/20 initiative
  • Identify guiding principles for a robust retirement system
  • Introduce those principles into policy discussions

• RSAP’s work has included:
  • Qualitative assessments of existing and proposed retirement system designs
  • Retirement policy issue briefs
  • Commenting on proposed legislation such as the SECURE Act
The AGES Principles

• The AGES principles provide a qualitative framework for evaluating the effectiveness of:
  • Retirement plans and systems (both public and private)
  • Retirement income policy proposals

• Four key principles:
  • Alignment between stakeholder roles and competencies
  • Governance that manages competing needs and reduces conflicts of interest
  • Efficiency in maximizing returns and minimizing risks
  • Sustainability of the system

• Does not address universal coverage or adequacy, and assumes existing Social Security programs remain in place
DB vs. DC – Is There a Better Way?

• The traditional DB plan does fairly well at Alignment and Efficiency, but not very well at Governance and Sustainability

• DC plans do better at Sustainability, but not as well at Alignment and Efficiency

• To better meet the AGES principles, plans likely need to move beyond the traditional DB/DC paradigm, e.g.:
  • DB plans with risk-sharing features
  • DC plans that pool investment risk and offer lifetime income
Risk-Sharing Designs

• In risk-sharing designs, a key question is how risk is allocated between the employer and employees
  • How much risk is “too much” for the employer? For employees?
  • Transparency is important so that each party understands the degree of risk they face

• All types of plans are subject to the same basic equation
  • Actual benefits = Actual contributions + actual investment return
  • In the event of adverse experience, either contributions must increase or benefits must decrease in order to maintain balance

• If significant variability in either employer contributions or employee benefits is undesirable, investment policy needs to take this into account

• Risk-sharing and other retirement plan designs also need to fit within a broader retirement policy
Toward a U.S. National Retirement Policy

• In 2019, the Academy published an issue brief on *National Retirement Policy & Principles* exploring the need for a comprehensive U.S. national retirement policy articulating guiding principles.

• Principles underlying a retirement policy should incorporate and address:
  • Availability of retirement programs
  • Benefit adequacy
  • Allocation of risks
  • Treatment of different income levels
  • Use of incentives
  • Individual choice
  • Costs
  • Portability and leakage

• The Academy has since published a follow-up issue brief on *portability and retirement income* and is working on issue briefs on risk-sharing and decoupling of retirement programs from the employment relationship.
Key Principles

Lee D. Gold
Key Principles for retirement plan of the future

• Retirement benefits / accounts attached to the employee, not the employer
• Employer and employee contributions
• Blend of capital accumulation and lifetime income
• Investment risks must be shared among all participants
• Sharing / avoiding other risks
  • interest rate risk
  • demographic risks
  • generational risk transfer
Retirement benefits / accounts attached to the employee, not the employer

- Referred to as “decoupling” in some of the current literature
- Individuals open a “retirement account” with an approved provider
  - “account” has both accumulation and income benefits
- Employers can contribute to employees’ accounts as desired
  - Match or non-match
  - Some form of non-discrimination testing would still be prudent
    - Coverage
    - Benefit levels
- Employees also contribute to their accounts as desired
Employer and Employee Contributions

• Employers are generally unwilling to contribute the amount of funds necessary to fully support an employee’s retirement
• Employees will need to fund a portion (50%+) of their own retirement
• Tax treatment of employee contributions should be the same regardless of the retirement vehicle used
Capital accumulation and lifetime income

- Retirees need lifetime income as well as access to capital
- Minimum and maximum percentages established to determine amount of contributions that go towards income benefit and how much goes to accumulation benefit
- Income benefits provided through a pooled arrangement
  - Not insurance. Too expensive if some entity has to take on risk.
  - Operates more like a tontine
- Lifetime income provision removes complex decisions around draw down strategies for at least a portion of the individual’s retirement
Investment risks must be shared among all participants

- Employers are unwilling to bear the burden of unexpected changes in asset values
- Employers will simply make contributions, no further obligation
- Individuals will see their retirement benefits adjusted based on asset returns
  - Benefit adjustments apply to both income portion and accumulation portion
Sharing / avoiding other risks

• Avoid interest rate risk
  • Design income benefits to eliminate this risk
  • Accumulation accounts do not suffer from this financial risk, so no issue

• Share demographic risk
  • For income benefits only
  • Income benefit amounts adjusted periodically (up or down) based on demographic experience.
    • Fewer deaths than expected during period – benefits adjusted down
    • More deaths than expected during period – benefits adjusted up

• Avoid generational risk transfer
  • Experience of one cohort does not impact the benefits available to another cohort
Variable Plans and the Future

Kelly S. Coffing
Focus on variable plans

• In a blue sky discussion, not everything is currently legal.
• But some things are.
  • Variable plans (variable annuity plans in the Revenue Ruling 1953-2)
  • 2014 hybrid regulations provide for several modifications to the variable design

My views are mine and do not represent anyone else’s views, including the SOA and Milliman.
Variable plan—very high level

- Benefits are funded at the time of accrual at the “hurdle rate”
- Thereafter, accruals adjust with actual returns compared to the “hurdle rate”
- Plan stays funded regardless of investment returns
- Market outperformance does not improve funding, it improves benefits
- Benefits typically accrue on career average, flat dollar, or contributions/hour basis
Variable plan—funding pattern

- Assets and liabilities move in lock step, dramatically reducing underfunding risk
- Ideal to hold some reserve to absorb gains and losses, asset timing mismatches, assumption changes, etc.
Variable plan—benefit pattern (in grey)
Modified variable plans

• Designed to smooth out the benefit pattern for retirees
• WARNING: Be aware of risks you may be adding back into the Plan
  • Model, model, model. Scenario testing and stochastic modeling.
• Results in smaller benefits for given contributions. Strategies have included:
  • Conservative asset allocation
  • Annuitization, adds back interest rate risk
  • Floor benefit, adds back interest rate risk, market risk. Floor may be “funded” by maintaining a higher funded percentage.
  • Cap & shore, called Sustainable Income Plan, maintains reserves to prevent benefit declines
• Plan design is about trade-offs

Certainty is expensive.
—Josh Shapiro
Cap & shore benefit—underlying benefit in green, Shore-ups and “excess reserve” increases in purple.

Chance of benefit reduction is very small but because reserves are maintained, benefits are smaller. This is the price of higher certainty.
## Risk summary for typical single employer designs

### Risks borne by:

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- **Investment risk**: not diversifiable, employers not interested in taking this on
- **Interest rate risk**: shows up in liabilities for employers, annuity purchase rates for retirees
- **Inflation risk**: not larger than salary scale for employers, can be significant for retirees
- **Longevity risk**: DIVERSIFIABLE, risk becomes more predictable when pooled
- **Fiduciary and compliance risks**: borne by the sponsor in all current designs
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Blue sky possibilities

• How do we get that risk profile?
  • Variable or modified variable plan (without any investment or interest rate risks added back in, so something like Sustainable Income Plan)
  • Variable adjustments incorporate investment returns as well as mortality and other demographic gains and losses and assumption changes (may need a law or guidance at least)
  • Funding surplus is always used for benefits (does not create contribution holidays)
    • Shoring up to prevent declines
    • Improving benefits
    • Ensuring benefits keep pace with inflation
    • Relax definitely determinable rules to allow for benefit adjustments to be tied to funding without plan amendment in the plan document
Bigger blue sky possibilities

• Contributions
  • Allow employer and employee contributions with preferred tax treatment in all plans (up to reasonable limits)
  • Employer contribution is percent of pay. Period.
    • Contributions fund benefits being earned now, not in the past
    • Would allow accounting like DC plans use
• Make decoupling retirement from employers available, not mandatory
  • Done through a SECURE Act for pensions
  • Retain longevity risk in the plan, so not all assets are in participant accounts
  • Builds economies of scale
  • Provides access to retirement plans for small/mid-sized employers
  • Moves fiduciary risk and plan management responsibility away from employers
Bigger blue sky possibilities

• Spending flexibility
  • Can this be done in one plan rather than two? Throw out DC vs DB concept and create one design.
  • One plan that allows for some lifelong income and some discretionary spending

• Behavioral economics
  • Benefits structured to avoid behavioral pitfalls
    • Have fewer (or good default) investment choices
    • Create more employee savings
Bigger blue sky possibilities

• Exemption from certain governmental programs
  • PBGC Premiums
  • Withdrawal liability for multiemployer plans

• Benefits allowed to adjust for events currently unseen
  • Benefits ultimately equal to contributions plus earning on those contributions
  • Benefits are what can be borne by those sources of income
Blue sky possibilities—reconsider stance on intergeneration risk transfer

• We should have SOME intergenerational risk transfer
  • Retirees need inflation protection, not asset growth
• Some generations get abundant returns, some get meager returns
  • 15-20% should get used to ensure reasonable benefits for all generations
  • Participants could get all of DC volatility and 80-85% of variable volatility
  • Allowing for better generation equity on lifelong income portion
• Just like lifelong income is easier to achieve when longevity risk is pooled, inflation protection is easier to achieve with some intergenerational transfer
Variable plan benefits—intergenerational transfer could improve 25%ile years, dampen 75%ile years

Projected Benefits under different return scenarios
Basic variable vs. cap & shore (Sustainable Income Plan or SIP)
What’s Next
Risk-Sharing Plans in the U.S.

• Risk-sharing DB plans exist in the U.S., but they are relatively uncommon
  • Examples include variable annuity plans and cash balance plans with market-based interest crediting rates

• Employers may currently be reluctant to adopt these designs due to regulatory uncertainty
  • Funding, accounting rules do not clearly address these plans
  • It is unclear how certain plan qualification rules apply to these plans – e.g., backloading, nondiscrimination testing, §417(e)
  • Elimination of determination letter program for ongoing plans
  • PBGC premiums continue to apply despite greater sharing of risk with participants

• It is also difficult to introduce collective DC features in U.S. plans in the current environment
  • Investment experience is passed directly through to participants with no real ability to “smooth” experience over a multi-year period
  • Pooling of longevity risk is limited to annuity payout options, and utilization of these options is limited

• Can legislative changes facilitate better solutions?
Examples from Outside the U.S.

• New Brunswick Shared Risk Model
• Swiss cash balance plans
• Other
Bluer sky legislation wish list

• Add a PEP option for DB plans
• Equalize tax treatment on employee contributions to DB
• Remove PBGC premiums for plans with truly sustainable benefit designs
• Allow for designs that share investment and demographic experience among participants
Blue Sky Wrap-up

• Technology and computing capabilities allow for more sophistication and broader thinking on plan design
• Move beyond the restrictive confines of DB versus DC
• Move beyond the restrictive confines of “single employer plans”
• Focus on providing retirees with income and wealth (not either / or)
• Remember: Certainty is expensive
  • Corollary: Total uncertainty is inefficient
2020 VIRTUAL ANNUAL MEETING & EXHIBIT