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Can Continuing Changes in Pension Management Provide a Secure Retirement?

by Toddi Gutner with Anna M. Rappaport

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At the heart of this transition is the evolving social contract between employees and employers and the impact on both. A gradually evolving definition of retirement raises controversial questions, especially from a societal point of view.

The Big Dilemma

First and foremost is the question: What is the responsibility of the corporation to provide a safe and secure retirement for its employees? In the age of defined benefit (DB) programs, retirement risk fell heavily on the plan sponsor. However, with today's seismic shift to defined contribution (DC) plans—many companies are now freezing or terminating their DB plans—often all of that risk falls to the employee; but is that appropriate? When employees are left on their own "they aren't making good [financial] decisions for themselves," says Joan Boughton, senior vice president of benefits consulting for Fidelity.

As a result, plan sponsors, policymakers, and academics are working together to rethink retirement benefits that make sense for today's retirees. Sweeping legislation, such as the Pension Protection Act of 2006, significantly strengthened funding rules and liberalized requirements for DC plans. But experts disagree over whether the new rules for DB plans will help stabilize the system or simply encourage more companies to curtail their plans. Further discussions are needed to understand how best to respond to the new definition of retirement in light of the changing demographics, the increasing risk individuals face of outliving their retirement income, and the need for lifetime income or other risk management processes in retirement.

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At a time of rising volatility and risk, plan sponsors must reevaluate their DB plans and decide whether to continue them as is, redesign, terminate, or freeze them. Simultaneously, they need to modernize their DC plans to include the accumulation of funds to pay for healthcare; offer features such as auto-enrollment, auto-increases, and new default investment options to help employees finance their medical benefits once they retire; and increase participation.

Employers are changing their DC plans so they work better for employees who don't take action. It is imperative that employees embrace the financial education that companies offer so they can learn how to fully use their benefits. But perhaps just as important is to determine how much savings is enough and to save that amount.

Redefining Retirement

Long gone are the days when older Americans are content to shuffle out of the workforce and sit idly by until the end of their days. The aging baby boomers of today are the best educated, healthiest, and longest-living group to ever enter retirement. Indeed, when surveyed, 7 out of 10 people in this population report that they want to continue working in retirement, according to Anna Rappaport, a senior fellow on pensions and retirement for The Conference Board.

Given these new parameters, new definitions and innovative employment options must be created for this phase of life. Rappaport calls it the "third age," which is the period between full-time work and total retirement. "Policymakers, employers, and individuals need to rethink how retirement fits into the way people live their lives," says Rappaport.

One option for accommodating the third age is phased retirement, which is when an employee moves from full-time to part-time employment—either with the same employer or another—before he or she completely retires.

Phased retirement has already gotten a great deal of traction, with 48 percent of current retirees transitioning into retirement through part-time work, but mostly on their own.[1] And more people are expected to incorporate this work style in the future.

This strategy is a win-win for both the employee and employer: Individuals have flexibility to continue working and generating income while the company can fill talent gaps. However, legal uncertainty remains around the rehiring of retirees, what determines a bona-fide termination, and when someone is an employee versus a contractor.

Employers are also still waiting for regulations on new Pension Protection Act provisions. For example, while the Pension Protection Act allows pensions from DB plans to be paid after age 62 to people who still work, it still doesn't clear up unanswered questions about rehiring retirees. The new provisions of the Pension Protection Act do not apply to DC plans, but they were not needed because DC plans were already able to provide distributions after age 59 ½ to employees who continue working.

Truth is, these issues are just growing pains and they will be addressed as society, companies, and individuals redefine retirement. In fact, they will probably be resolved sooner rather than later as more and more companies consider at least an informal approach to phased retirement. In a poll taken during a webcast conducted by The Conference Board, 59 of 69 respondents said they are likely to have a phased retirement program within three years.[2] Several programs, such as those by Bon Secours, YourEncore, and Weyerhauser, can serve as model solutions for companies looking to initiate a phased retirement program in the future. Of course, each organization needs to match a solution to its own needs and situations.

1 Georgetown University Law Center, "Workplace Flexibility 2010," August 2007.

2 "Phased Retirement after the Pension Protection Act," webcast, The Conference Board, June 26, 2007.

Burdening Employees with Risk

The decline in DB and rise in DC plans in conjunction with increased longevity has made for a perfect storm of rising employee risk in managing personal retirement benefits. "We are asking employees—who should be seen as consumers, not investors—to take on significant risks that they haven't a clue on how to manage," says Zvi Bodie, a management professor at Boston University.

The risk is twofold. The first concern: Employees will outlive their retirement income and will experience a significant decline in their standard of living as they move from the accumulation phase. This is entirely possible as "many people are underestimating their life expectancy and overestimating how much money they can draw from savings," says Jody Strakosch, national director, institutional income annuities for MetLife. Employees are facing new responsibilities for managing retirement assets, distribution options, and the payout period, and many are unable to manage the process effectively.

The other danger is that employees are investing more than they should in equities, due in part, to the limited options for their DC monies, inflation, and market volatility. "Target date funds, which have been endorsed by the Department of Labor and the Employee Benefits Security Administration for default investment options, are way too risky for the average employee," says Bodie.

More Pension Changes Are in the Wind

Today, several organizations are exploring new ways to manage retirement planning issues. The goal of The Society of Actuaries' Retirement 20/20 project is to find new pension systems models and innovative ways to share risk between participants and plan sponsors.[1] The multi-disciplinary project focuses on the needs, risks, and roles for different stakeholders, as well as explores the effective use of the market and re-examines employer roles and the methods to distribute benefits, among other topics.

In addition, ERIC (the ERISA Industry Committee), an organization of major employers in the United States, introduced a series of proposals for sweeping changes in the way retirement and health benefits are delivered in the United States. Some of the most important features of its "New Benefit Platform for Life Security"[2] proposal, which was released in June 2007, include:

- Making embedded purchasing cooperatives available to employers and individuals
- Having employers offer their own plans, use a purchasing cooperative, or provide vouchers
- Providing standard benefit designs specified by law
- Requiring mandates so that individuals who do not have employer-provided benefits are obligated to buy retirement and health benefits
- Leveling the playing field for those with and those without employer-sponsored coverage
- Making tax benefits to the individual the same whether the employer sponsors the arrangement or not
- Providing DB, DC, and short-term savings components in the retirement proposal

This proposal, which a number of companies in the business community support, is likely to garner attention, especially since it touches on health benefits. U.S. presidential candidates are certain to focus on health reform proposals, in particular, for the 2008 election.

If adopted, it would change the employment landscape for older workers, the means of competition in the labor market, and therefore the social contract. In addition, the health proposals would entirely change the retirement timing and management landscape because individuals would no longer depend on current or former employers for their healthcare. This would remove the link between healthcare benefits and retirement decisions.

Potential new solutions such as these are controversial, but major employers continue talking about using outside solutions to support retirement security, nonetheless.

By Anna M. Rappaport

1 Society of Actuaries, "Retirement 2020," www.retirement2020.soa.org

2 www.eric.org/forms/documents/DocumentFormPublic/viewDoc?id=B98400000007

Mitigating the Risk

One solution to such uncertainty, suggests Bodie, is to create options that provide lifetime income, such as inexpensive and flexible annuities. Bodie cites Fidelity's new Growth and Guaranteed Income Fund, which is designed to protect consumers on the downside, as one such example. Offering employees in-plan opportunities to purchase income annuities with their DC assets can also provide lifetime income. Programs that allow a roll-over into IRAs with institutional annuity rate purchases are another way to accomplish this.

Bodie's comments are counter to the actions that many plan sponsors take, and his views are controversial. When a DC plan is provided along with a DB plan, the DB plan offers secure retirement income and helps the employee balance risk. When only a DC plan is provided, then the employee needs to think about managing his or her own risk.

Big questions remain, specifically about the future of risk and lifetime income, and about what policy options should be considered and whether there should be legal requirements for the employee or the employer to purchase a lifetime income benefit. Right now, "it's unrealistic to require a mandated annuity beyond Social Security," says J. Mark Iwry, a senior fellow at The Brookings Institute. Other options that incorporate annuities into different products, such as bundling annuities with long-term care insurance or having Treasury-issue low-cost TIPS annuities available to consumers and plans, may also be a reasonable solution.

Savings Shortfalls: How to Close the Gap

The need to provide for healthcare costs leaves a gaping hole in today's retirement security benefits, says Fidelity's Boughton. An average couple who retires in 2007 at age 65 is estimated to need $215,000 in the bank to fund future health care costs over and above what Medicare will pay, according to Fidelity Consulting. When you compare that with estimated current account balances of $128,000, the shortfall is striking.

The average employee is on track for 58 percent of replacement income, far below the goal of 85 percent. Replacement income is the percentage of your current salary that you would need during retirement. For example, if your income prior to retirement is $100,000, then 58 percent replacement income would mean you would have $58,000 of income during retirement.

Perhaps even more surprising, "people's behavior is not changing," according to Boughton, who says that participation rates in defined contribution plans actually declined from 60 percent in 2003 to 57 percent in 2006. While account balances are gradually moving up—from an average of $55,200 in 2003 to $66,500 in 2006, there is a "mismatch on how employees are protecting themselves," says Boughton.

As a result, employees may end up staying on the job longer than they want because they can't afford to retire. The cost to the employer: One company says that its total pay and benefits cost an estimated $30,000 more per person per year for its age 60 employees compared to those who are age 35, according to Boughton. "Health care costs are squeezing out other benefits and that puts companies at a competitive cost disadvantage," she says.

The solution has many facets. First, new plan designs—those integrated programs that cover savings but roll in provisions to provide more money for healthcare—must steer employees to make a trade-off of less disposable income today in order to save for medical costs in retirement. Employees need to be willing to choose less comprehensive medical plans, such as consumer directed high deductible plans with health savings and reimbursement accounts.

Automatic enrollment should also be included in new retirement plan designs so that DC plans can work without active employee participation. It seems that inertia is what causes employees to not participate in defined contribution accounts. Participation rates jumped from 53 percent to 81 percent with automatic enrollment, according to Fidelity's Boughton. "We need defined contribution plans that work for people who don't take action," she says.

Finally, a new view of total compensation must be established from salary and benefits to lifecycle benefits, which include daily living, wealth accumulation and preservation, and security. A five-step process from Fidelity outlines how to put lifecycle benefits into action:

Step 1: Increase features for an auto-savings plan and focus on retirement readiness education.

Step 2: Communicate the value of benefits in dollars and address tax efficiency.

Step 3: Organize and simplify benefit programs.

Step 4: Market programs based on employee lifecycles.

Step 5: Provide flexibility with default allocations for how employees receive their compensation.

Employer Quandary: To Freeze or Not to Freeze DB Plans

Employers continue to ponder what their financial responsibility is to their workforce and whether or not to freeze/terminate their DB plans and transition to a DC plan. In order to make the right decision, all financial implications must be taken into account, advises Robert (Bob) Aglira, a worldwide partner at human resources and financial consulting firm Mercer. Each option has unique financial challenges that have an impact on how a company controls its pension risk. New methods of managing the risk without freezing or terminating the plan are also available.

The day of reckoning for FMC Corporation, a global chemical manufacturer, came after a spin-off of its machinery business and the recession of 2001–2003. Low interest rates, poor investment returns and lagging performance created a devastating maelstrom for FMC Corp.'s DB plan. "We didn't know whether the Pension Protection Act would make our DB plan more volatile and we were worried that as a smaller company we couldn't effectively manage our business with the increased the financial risk," says Kenneth Garrett, vice president of human resources and corporate communications for FMC Corporation.

With the help of Mercer Human Resource Consulting, FMC assessed the prudence of its DB plan. To attack the problem, it surveyed the chemical industry and conducted focus groups with human resource managers, line managers, and employees.

The industry results were enlightening. With more than three-fourths of the chemical companies responding to the survey, some 64 percent had either recently closed their DB plans and froze benefits or anticipated closing the plans to new hires and freezing benefits in the next two years. The reason? "Cost control was the primary objective of these changes for 80 percent of the companies," says Aglira, "while 60 percent said cost reduction. Cost control really means reducing volatility and cost reduction is only achieved through new benefit design."

Manager and employee focus groups also helped FMC to make a better decision. The human resources managers were most concerned about losing valuable mid-career employees and being able to attract new talent, while the line managers were worried about the morale of the workforce if there were a change in benefits. "We learned that we as a company had a moral obligation to our employees to help them with retirement," says Garrett.

In addition, the focus groups helped FMC realize that even if it eliminated the DB plan, employees may still need to stay with the company since there were minimal employment options in the area. Finally, FMC learned that "retirement benefits were better for retaining than attracting employees," says Garrett.

FMC made a decision to freeze its DB plan for new employees effective this past July and provide the newer and younger employees with a portable account-based plan. This falls in line with the recent trend. In the past two years, 25 percent of employers closed their DB plans to new hires and 13 percent froze the plans for all employees, while 30 percent of employers plan to do so in the next two years.[3] The FMC evaluation process and experience can be used as a template for other companies that are evaluating their DB plans to control pension risk.

Today's increased financial transparency, which has resulted in companies moving their DB funding status from the annual report footnotes to the balance sheet, makes it imperative that they control their pension risk better. "That can be done through investment policy by reallocating out of equities and into long-term fixed income," says Aglira, who cites a reduced risk of 50 percent after changing allocations based on several different financial models.

While it makes sense to run these complicated statistical models to protect a company on the downside, such financial finesse leads many employers to question whether they should just administer retirement benefits rather than provide them and bear the pension risk.

3 Jack VanDerhei, Temple University and EBRI Fellow, "Retirement Income Adequacy after PPA and FAS 158: Part One–Plan Sponsors' Reactions," *EBRI Issue Brief*, #307, 2007.

Employee Conundrum: How Much Do I Save?

While it's clear most Americans aren't socking away enough for a secure retirement, there is a controversial debate waging about how much is enough. Common knowledge says that the average amount needed for retirement is somewhere between 70 percent and 90 percent of an employee's final pay. Raymond J. Murphy, director, U.S. benefits plans for Campbell Soup Company, argues that individuals don't need a 100 percent replacement ratio because they will need less income. Presumably, they will have lower costs because they may be in a lower tax bracket, no longer pay FICA taxes, and no longer need to save for retirement. In addition, some will have paid off their mortgages.

Does Consumption Planning Make Sense?

A wide range of planning methods are being used to estimate retirement needs. Replacement ratios make sense from the employer's point of view, which assumes that employees are spending most of their income before retirement and are not going to experience major changes in expenses.

For individuals, focusing on consumption planning makes a lot of sense. However, they need to pay close attention when planning. Studies have shown that people tend to overestimate expected investment returns, underestimate life expectancy, and underestimate the likelihood that they will need long-term care.

Consumption planning depends on accurate input and can vary, depending on an individual's specific spending needs. Employees who pay off their mortgages at the time of retirement, or move to much less expensive housing, or complete paying for large college bills are likely to need less than the traditional replacement ratios.

In contrast, employees who spend most of their income on themselves and their spouses (rather than children) and lose their access to employer health benefits at time of retirement, or who want to spend extra funds to travel more will find that they need more than the traditional replacement ratios. Planning for consumption makes sense, but it should include provisions for risk, including unexpected major health events and long-term care.

By Anna M. Rappaport

To achieve one's replacement target ratio, Murphy espouses the 12/10/5 rule, which means:

- 12 percent: contribution as a percent of pay needed each year for 40 years
- 10x: ratio of account balance to final pay needed at age 65
- 5 percent: percentage of your account balance that can be withdrawn in the first year of retirement

Of course, most people aren't disciplined enough to implement the 12/10/5 rule—participation rates for employees under 30 are less than 50 percent, the median account balances for employees 60 to 64 is $42,000, and withdrawal rates for participants in their 60s average about 8 percent of the account balance. Even if an individual does follow the 12/10/5 rule, poor investment returns can upend a savings plan.

Laurence Kotlikoff, an economics professor at Boston University, argues that the often-quoted replacement ratio of 70 percent to 90 percent is "way too high for most households" and that for some an estimated 40 percent is a more realistic number. "People are making all sorts of mistakes with portfolio choices, insurance, and savings" says Kotlikoff. That's because there are more than four dozen variables, tax, and social security details to consider per individual, and typically they are overlooked when calculating the replacement ratio.

To more accurately calculate how much an individual needs to save, Kotlikoff uses the consumption smoothing approach to financial planning. This strategy attempts to get an accurate living standard for an individual and then lets the savings fluctuate rather than the conventional wisdom of the other way around. "With economics, you can find the right target," he says, and in the process, raise your standard of living.

Saving Made Easy

Engaging and motivating employees to take charge of their retirement savings requires a tremendous amount of effort on the part of the employer. Rachel Weker, vice president of T. Rowe Price Retirement Plan Services, has identified six trends that most effectively and efficiently communicate and motivate employees:

- Tell employees how to do what they need to do.
- Communicate relevant and personal messages.
- Make plan participation easy.
- Emphasize the use of the web as a communication tool.
- Focus on retirement income, not lump-sum payouts.
- Provide a human touch.

John L. Merino, chief accounting officer of Federal Express, used some of Weker's strategies. His challenge, he says, is that "employees didn't understand what they had before and how much it cost." FedEx had frozen its DB plan and moved everyone prospectively to a cash balance plan, which reduced the company's projected benefit obligation by $1 billion. To gain his employees' trust, Merino established a sound communication plan that incorporated the following steps:

- Making the communications strategy a campaign, not an event (sample marketing campaign: Plan today, play tomorrow.)
- Establishing realistic expectations
- Communicating through multiple channels, such as Internet, corporate TV, and mailers
- Providing modeling tools rather than examples
- Sending regular statements that demonstrated the employee's dollar value. "They could see and watch it grow every month," he says.
- Ensuring that employees had the opportunity for face-to-face meetings with subject matter experts

Different from what most companies are doing is Weyerhauser's Healthy Wealthy Wise Retirement Planning Seminar. This unique and well-received educational program runs two-day offsite workshops for employees. Sally Hass, the benefits education manager at Weyerhauser, says her monthly programs are typically booked a year in advance.

After each program, a significant number of attendees actually change their behavior, often committing to and following through with seeing a financial planner. How does Hass account for her success? Rather than focus on retirement data and numbers like most companies' educational programs, Hass motivates employees to take action because she zeros in on how to make the information relevant to each individual's life. "She helps people to manage their lives so that retirement planning makes sense to them," says Rusty Field, vice president of workplace financial planning for Ameriprise Financial.

Conclusion

As retirement benefits are redesigned to meet the new challenges for today's retirees, it is unclear whether employer programs can support long-term financial security. The evolving social contract between employees and employers has many unanswered, controversial questions that plan sponsors, policymakers, and academics need to work on together to resolve.

Lessons from Behavioral Finance

An emerging body of knowledge provides new insights into how people understand and deal with risk and uncertainty. According to research by the Society of Actuaries, gaps and misunderstandings in knowledge still exist in the public's understanding of risk despite the need to assume more responsibility for financing retirement. For example, many individuals nearing retirement consistently overestimate what their savings will provide and underestimate how much of their income will come from Social Security. Retirees deciding how to invest their money often focus on the shorter-term rather than the rest of their lives.[1] And if things do not work out, they will often not know that until years later. Other research, such as that on defaults from Dr. David Laibson of Harvard University, indicates that many employees start in default options in 401(k) plans and do not move out of them. That has led to new structures for these plans, including auto-enrollment, auto-increases, and new default investment options.

Readers interested in learning more about economic behavior as it applies to pensions may wish to consult *Pension Design and Structure: New Lessons from Behavioral Finance*.[2] This work contains a discussion on why retirement savings is so difficult:

- the payoff for behavioral change is quite uncertain;
- workers do not easily buy into the idea of payoffs in the distant future;
- the promise of pleasure tomorrow is perceived as meaning pain today;
- wrong decisions may yield instantaneous gains;
- there is no immediate tangible reward for saving now;
- savings decisions can be postponed without immediate penalty; and
- there are no specific functional deadlines for actions.

By Anna M. Rappaport

1 "Spending and Investing in Retirement: Is There a Strategy?," Society of Actuaries and LIMRA International, 2004.

2 Olivia Mitchell and Stephen Utkus, *Pension Design and Structure: New Lessons from Behavioral Finance*, Oxford University Press, 2004.

About the Authors

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