Changes in Pension Benefit Formulas

Why the Trend is Change in Defined Benefit Plans:

How Executives Can Adapt to Changing Pension Benefit Formulas

Major American corporations have invested mightily in providing benefit packages that allow them to attract and retain a competitive workforce. Traditional pension plans have been an important part of total benefit packages historically, serving as both a means of retaining employees throughout their careers and rewarding length of service with generous lifetime income. The goal of pension benefit plans is to provide a predictable benefit at retirement according to a specific formula. The retirement landscape has been changing and this white paper provides an overview of the employer's dilemma driving announced changes and the impact on executive incentive plans and retirement income strategy.

The Employer's Dilemma

Historically, earning a guaranteed lifetime income benefit has been among the most popular of all employee benefits. Pension benefits have tipped the scales when employees chose where to work, at least in part. They also know that their rewards are typically based on years of service, age and their final (or final five-year average) compensation.

Contributions to pension plans provide a tax-effective way to compensate employees. The employer takes a current year deduction on the amounts set aside in trust to fund the plan, while the contributions are not taxable as current income to you, as the employee. But, the employer faces increased risk and uncertainty associated with their pension expense, namely longevity risk, investment risk and estimation or actuarial risk.

The amount your employer sets aside annually in a trust is reserved to fund eventual pension obligations. The debt is open-ended; if the eventual benefit exceeds what has been put aside, the employer must step in to meet the obligation. The employer is at risk to ensure the trust can meet its obligations; no matter what, your employer is responsible for meeting the benefit payments when due.

The unpredictability of expense required to guarantee these benefits is the problem for public companies and other organizations. To anticipate and lock in their pension expenses well into the future, all but a handful of industries have moved away from traditional pension benefit plans in favor of either cash value plans or 401(k) defined contribution plans.

As life expectancies have lengthened, retirees are living longer and the cost to ensure a guaranteed income for life has become more expensive. Markets fluctuate and, just as outperformance of the employers' investments can lead to overages in the employer's favor, shortfalls due to poor investment returns or unforeseen plan design flaws, employers must make up the shortage out of current income.

Employers have been moving to shift the risk from employer to employee to gain more predictability around pension expense. That is why defined contribution plans (i.e. 401(k) plans) have become the standard bearer in most

Fortune 500 companies, replacing defined benefit plans (i.e. pension plans). Several of the remaining employers who still offer a pension plan have announced plans to either freeze or alter them; however, we offer no grim predictions for the demise of the remaining defined benefit plans. We simply cannot predict the future in the pension arena.

The move away from traditional pension plans shifts the burden of retirement saving and investing onto the employees. Employers can predict the extent of their employer **contributions rather than eventual benefits,** whether by paying a fixed formula for a cash balance plan or agreeing to match employee salary deferrals and committing employer contributions in a defined contribution plan.

Here's the bottom line: Employers are finding it beneficial to guarantee their contributions to the benefit plan rather than guarantee the retiree's lifetime income for an undetermined number of years into the future.

Today's Executives Are Nimble and Financially Driven

Today's rising executives are more nimble and do not expect to spend their entire careers with a single employer. Some of the attitudes and behaviors of younger workers are captured in Deloitte's 2019 Millennial Survey. In it, millennials and Gen Zs are reported to be increasingly pessimistic and mistrustful of both their careers and the world around them. Earning a high salary and being wealthy ranked second (52%) among ambitions, behind traveling and seeing the world. But when asked whether their ambitions of wealth were achievable, the respondents ranked this aspiration in the last position, with 60% of respondents seeing it as a possibility. Generally, though, millennials believe their ambitions are within reach. Two-thirds who want to reach senior levels in their careers believe that's attainable.

It follows that flexibility is key to meet the aspirant generations' visions of job mobility. "Younger executives value the portability of their pension benefits," said Stephen Bowers, Counsel in the Tax and Estates practice at White & Williams.

This is significant when you consider that median employee tenure is generally lower among younger workers than older ones, according to the Bureau of Labor Statistics. Among the pre-retirement age cohort of ages 60 to 64, 54% had been employed for at least 10 years with their current employer compared with only 10% of those ages 30 to 34, in January 2020. (Recognizing the expected correlation between age and long tenure, the gap is still substantial.)

Those who work for multiple employers over a career may prefer to maintain control over the destination of their retirement savings and investments, along with their career. The 401(k) allows you to bring the account with you when you exit the employer, and either move the 401(k) via direct transfer to the new employer's plan or roll it over into a 401(k).

These plans make it easier for the employer to fully anticipate their costs in a defined contribution plan. Only 16% of Fortune 500 employers offered a defined benefit plan (traditional or hybrid) to salaried new hires in 2017, down from 59% in 1998. Fifty-one percent of these companies still employ workers who are actively accruing pension benefits, and 93% of those who sponsored a DB plan in 1998 still manage plan obligations and assets.

This mix of old and new plans, the grandfathered and the legacy plans, blending the older with the newer plans with predictable contribution formulas – together they pave a path of several decades at least before employers finish out legacy plans and allow for predictable pension funding expenses.

Traditional Benefit Plan Formulas Favor the Well-Tenured Close to Retirement

The benefit accumulation formulas in traditional pension plans favor employees who are nearing retirement age, a function of years of service, age and either your final salary or final five years of salary. These factors escalate toward the end of your career, to the disadvantage of someone who leaves the company before the last five years of their career. (There may be an integrated formula that includes Social Security up to the FICA contribution limit. A lot of formulas recognize a higher percentage above the Social Security wage limit.)

An executive who leaves the employer after 12 years and is still in her 40s, walks away from pension accumulation accounts. Pension portability would be an attractive feature to this executive.

Announced Modifications and Changes to Pension Plan Benefits

Few announcements are met with greater dread and skepticism than when your employer announces changes and modifications to the pension plan benefits. Now that you understand the drivers that are causing the change, it is best to stand back and study the changes. "Often, the assumption that the company is trying to save money could be incorrect," according to Matt Witter CFP®, Co-Owner and Senior Vice President, SFG Wealth Planning Services, Inc. The pension fund changes often represent a de-risking by the company or a desire to predict their pension expenses, rather than reduce or cut benefits. It is important to dig deeper and analyze the changes in the pension formula objectively to understand what is going on, what the employer is aiming to achieve, along with analyzing the direct impact to you and your carefully developed retirement plan.

An announcement that the employer will change the pension formula, freeze or discontinue a pension plan can be worrying and consequential. As you read to discover what the changes portend for you personally, it can cause additional worry if the employer's benefit memo is highly technical, unclear or so broadly based that you cannot decipher the impact on your personal circumstances. Some of the common plan modifications may include:

- Freezing the defined benefit plan benefit
- Modifying the pension benefit formula
- Converting from defined benefit plan to cash balance plan
- Introducing a 401(k) defined contribution plan
- Or some combination of the above.

Freezing

The first move is often to freeze defined benefit plans, which allows the employer to lock in the pension obligation and fund it up through the discontinuation of the plan. "An employer may announce that a plan is outright frozen, that there will be no further accruals in the plan. Then the employer is likely discontinuing the plan," said Stephen Bowers, Counsel to White and Williams. "Freezing is a move by the employer to control its costs. This is not disastrous because, when a plan is terminated, another plan is almost always put in its place, such as a cash value plan or a defined contribution plan." It is wise to await the announcement and assess accordingly.

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Modify the Pension Benefit Formula

Another common announced change is a modification of the pension benefit formula. It is not unusual for an employer to modify the pension benefit formula to accommodate early retirement offers or to discontinue eligibility to new hires. In this case, the modification may or may not affect you at all.

Convert to Cash Balance Plan

Often, an employer announces a conversion from a defined benefit to a cash balance formula, in advance of a future effective date. A cash balance formula is an alternate method of describing the defined benefit formula.

The cash balance plan is a defined benefit plan where the promised benefit is presented as a stated account balance. In a cash balance plan, the employer sets aside a notional account, a book-entry account for each eligible employee, defining the amount that will be set aside annually. The notional account is given an accrual or notional interest rate which, when you retire, becomes yours in total.

A cash balance plan introduced near the end of your career would be a negative, because you would miss out on the accrual that occurs in the last five years of working; thus, it would not include a significant part of the accumulated benefit of the last few years. If you are a younger employee who prefers the portability of defined contribution plan, the cash value plan could be a benefit.

The Election Will Be Final

Changes in pension formulas may look minor and are often slated to commence one or more years in the future and start small. Don't be lulled into taking such changes lightly. It is often the case that you are required to make a series of elections that are binding and irrevocable. This is a cautionary tale to suggest you think carefully before committing to pension elections.

There can often be a slew of alternatives from which to select your future benefit, including choosing between a lump sum benefit or a monthly annuity income. The election is irrevocable. The law requires that each of the options be actuarial equal. "Personal circumstances are going to drive an employee's decisions, such as whether to elect a lump sum vs. annuity payout; choosing a lifetime annuity for the executive alone vs. a joint-and-survivor annuity with your spouse, which could offer a guaranteed payout over ten years," Mr. Bowers said.

Lump Sum Option – If an employer is offering a lump sum option for the first time, this is often a de-risking strategy to wind down the defined benefit plan. The employer may prefer paying the retiree a lump sum of a predictable fixed amount rather than carrying a future debt on its balance sheet. In addition, the employer saves the additional expense of laying off the annuity risk on an insurer.

Changes to a pension benefit may represent a curveball: are you potentially better or worse off? It's important that you get to the bottom of it.

Monthly Payout - You may elect a monthly payout and still face multiple options, such as whether to include your spouse or choose a single payee and take a higher monthly payout. It is important to remember that retiree medical benefits are often tied to the pension benefit. Bowers provides an example of a hypothetical retiree who looks at his pension plan and chooses the higher single payee option, believing he would outlive his spouse, due to her chronically fragile health. The retiree chose the lifetime annuity in that case, preferring the greater sum up front and the more generous monthly payout available when the plan is guaranteeing only one life. In this case, he is thinking about monthly benefit and not retiree medical benefit being tied to the terms of his plan. Then the unthinkable happens: the retiree passes away suddenly, leaving the spouse unprotected – with no stream of payments, without medical benefits and in precarious health.

The scenario planning conversations around pension benefits may not be pleasant or welcome conversations, but they are important ones. Simply put, you cannot afford to make pension elections in isolation, without considering the overall impact on your financial plan and retirement income strategy.

When you have both pension and Social Security benefits, you must make important irrevocable decisions and these choices are binding; you cannot afford to make the wrong ones. Decisions such as when to initiate pension and Social Security benefits, with long-term incentives (LTI) in the mix, are very important planning decisions. Consulting a professional is crucial to determine the best path based on your unique circumstances before making these elections.

Planning for Unplanned Retirement

You may retire earlier than planned. Circumstances change. Health events crop up. Families move and parents want to follow their grandchildren. Reductions in force take hold through voluntary termination. Whatever the reason, 53% of pre-retirees said they expected to retire at age 65 or older. However, 54% of actual retirees said they actually retired at the age of 61. Among 2,000 retirees surveyed, a majority — 56% — said that they retired sooner than they had planned. Nearly half — 46% — stopped working immediately as soon as they retired, but 19% phased into it. How might your pension election have changed if you knew there was a possibility you would exit before your planned retirement date? How would the combination of private pension, savings and public pension or Social Security provide you with the means for a seamless transition?

Pension Protection: The Backstop Stops Here

Pension plans are protected by the Pension Benefit Guarantee Corporation https://www.pbgc.gov/ (PBGC), a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA). The PBGC ensures the pension benefit in cases where there is a distressed termination, so the benefit is protected and guaranteed up to the stated protection limit, (similar to how the FDIC has a protection limit for banks.) Should a company go through a stressed termination, at a time the company is not able to pay the full extent of the benefits owed, the PBGC steps in to make up the shortfall. Most people receive the full benefit they had earned before the plan terminated. PBGC is an agency of the US Government whose financing comes from insurance premiums paid by companies whose plans are protected, from PBGC investments, from the assets of pension plans PBGC takes over as trustee, and from recoveries from the companies formerly responsible for the plans.

Mind the Gap

Often there is a gap between retirement age and social security age. You may defer your pension election decision to maximize your benefit amount, leaving a gap that can be filled by option exercise or another approach using long-term incentives (LTI) for income that may cover the years up to age 65. This is often preferable to accepting a reduced pension amount by drawing down your pension too early. Instead, you can preserve your higher monthly pension benefit by drawing first from other income sources. Compare scenarios and drawdown strategies to find out what works best.

A benefit formula change may trigger a reexamination of all your assumptions to gain an invaluable perspective of a financial professional, who can evaluate all these variables in view of your personal circumstances.

Which Election Shall Be Your Selection?

There is no pat answer to whether to elect a monthly pension income or a lump sum; it depends on your individual situation. For the executive who is counting on it, the monthly income stream would be the driving force for your election and what other decisions you make. If you have substantial savings, you may not need but may still want the guaranteed income stream from your pension benefit. But if you have sufficient retirement income, you could decide a lump sum provides you with maximum flexibility and control. Control over the investment selection could allow you greater leeway with your finances and may offer you the potential to earn a better return than the guaranteed payments.

“A lot of it comes down to controlling living expenses. A client who is good at keeping expenses low might have expenses covered by the old pension amount plus Social Security. For this person, the prospect of a lump sum payment after 15 years would provide a windfall,” said SFG’s Witter. “If he does not need the income, he could put the lump sum to work in an investment account that could grow generously over time.” This executive would potentially gain increased flexibility and control, knowing his living expenses are covered. A medical bill of $50,000, a nursing home stay or the chance to invest in a retirement business – these are all possible uses for a lump sum.

How important is legacy planning, leaving an estate behind to family or charity? What strategy may allow you to maximize your estate?

That depends on your goals. Keep in mind the possibility that you could predecease a spouse or children. In this case, the private investments may or may not be sufficient for your survivors. It may make sense to run scenarios on each alternative to determine the best selection.

You have only so much time to devote to personal financial planning issues and perhaps you don't have the interest or expertise, preferring to outsource the financial advisory role to a firm which can give you the bottom line. There may be substantial benefit to having us spend several hours to get to the bottom line, our best advice, rather than having to drill down yourself, having to learn the jargon associated with pension language and hoping you have considered a range of eventualities.

Equity Granted
An Executive Chat

We invite you to learn more about pension planning by joining our podcast on this topic with Matt Witter and Steve Bowers. You can find Equity Granted: An Executive Chat, wherever you access your podcasts or on our website at www.sfgadvisors.com.

Conclusion

You would be wise to explore the pension fund changes and their impact on your overall retirement plan. Changes can upend the formula and require you to rethink assumptions and examine alternatives. There is no simple answer to whether it is better to take the lump sum or annuity option. Elections are irrevocable and you need proper consideration and advice. Changes to a pension benefit may represent a curveball: are you potentially better or worse off? It's important that you get to the bottom of it.

Some employers offer an overwhelming number of options – where do you start with the analysis? The work involves running an analysis and knowing what is most important to you, assumptions about how long you are going to live, making the range of possibilities as concrete as possible before you make an irrevocable a pension election.

At SFG, we accompany you through an exploration that includes goals, a full range of questions, and lifetime consideration. We undertake an analysis of assets and income, spending needs in retirement, life expectancy and other variables. The long game is about ensuring within a high degree of probability that you will not outlive your money in a world that is not completely within your control.

[i.] *A Generation Disrupted: Highlights of Deloitte's 2019 Millennial Survey, by Michele Parmale: A Generation Disrupted, https://www2.deloitte.com/us/en/insights/topics/talent/deloitte-millennial-survey-2019.html*

[ii.] *Ibid.*

[iii.] *Employee Tenure in 2020, Bureau of Labor Statistics, September 22, 2020. https://www.bls.gov/news.release/tenure.nr0.htm*

[iv.] *Study Finds Shift in Retirement Offerings, by Ted Godbout, February 28, 2018, American Society of Pension Professionals and Actuaries. https://www.asppa.org/news/browse-topics/study-finds-shift-retirement-offerings*

[v.] *Helping Employees Decide When to Retire, by John Iekel, May 3, 2019. https://www.asppa-net.org/news/helping-employees-decide-when-retire*

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