Balancing Risk:

Designing and Implementing an Adjustable Pension Plan

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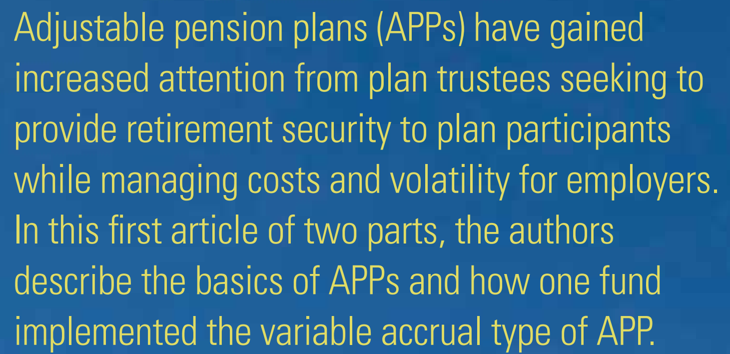
First in Two-Part Series



Adjustable pension plans (APPs) have gained increased attention from plan trustees seeking to provide retirement security to plan participants while managing costs and volatility for employers. In this first article of two parts, the authors describe the basics of APPs and how one fund implemented the variable accrual type of APP.

Over the last 20 years, many plan sponsors and providers have replaced their traditional defined benefit (DB) pension plans with 401(k)-style defined contribution (DC) plans with the goal of controlling costs and minimizing the volatility of contributions.

But one of the risks of disbanding a traditional pension plan and moving participants to a DC plan is that it leaves participants to fend for themselves and may result in lower benefits. Plan sponsors that seek to provide the best of both traditional DB plans and DC plans may want to consider adopting an adjustable pension plan (APP).

APPs—so called because they let plan sponsors adjust either the accrued benefit or future benefit accruals—are also frequently referred to as *variable pension plans*. For the sake of simplicity, this article refers to them as adjustable pension plans or APPs.

These plans are still DB pension plans and offer participants lifetime retirement income security so they don't have to worry about outliving their benefits, although those benefits may fluctuate depending on the plan's investment performance and design. The advantage for plan sponsors is that by sharing risks—including investment risk—with participants, they can better manage funding and accounting requirements. That makes these plans more affordable than traditional pension plans. These types of plans can also improve the sustainability of multiemployer plans by encouraging new employers to join and limiting withdrawal liability. And, because they reduce their unfunded liability, they help single employer plan sponsors minimize the variable rate premiums they pay to the Pension Benefit Guaranty Corporation (PBGC).

There are many forms of APPs, and each design allows plan sponsors to select features that best suit their objectives and the needs of their participants. This series of articles will describe and offer case studies on two types of designs.

1. The **variable annuity plan** may adjust the entire accrued benefit that a participant has earned based on the plan's investment performance. Depending on the features adopted by the plan sponsor, participants have a choice to either receive their pension as a fixed monthly annuity or as a monthly benefit that will continue to fluctuate annually to reflect the plan's investment returns during their retirement years.
2. The **variable accrual plan** may adjust only future benefit accruals to reflect changes in the plan's funded status and plan costs. Benefits that participants have already earned do not change.

Part Two of this series will appear in the March issue of *Benefits Magazine*.

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Setting Up an APP

Key Design Decisions

When setting up a plan, key design considerations include the following:

- **Will it be a pure variable design?** Sponsors need to discuss whether the benefits should be entirely variable or whether the plan should have a floor guarantee so that benefits never fall below a predetermined level.
- **What will the hurdle/accrual rate be?** The board of trustees' risk tolerance and objectives should be considered when establishing these rates.
- **Should a save-and-restore approach be used to provide downside benefit protection?** Rather than using all of the excess investment earnings to increase benefits, sponsors may use part of the excess earnings to fund a contingency reserve. The reserve may then be used to offset benefit reductions that might otherwise occur because of poor investment returns.
- **Should transition benefits be provided for older workers?** It is important to review projected benefit levels before and after any plan changes. Reviewing the projected benefits will show whether certain demo-

graphic groups are expected to receive increased benefits compared with others. It will also spur the discussion of whether to consider different benefit levels for different age and service combinations.

- **Should enhanced early retirement benefits be offered?** Subsidized benefits can be costly, and not all members will be eligible for them. Rather than providing a subsidized early retirement benefit to some, plans may consider providing a higher normal retirement benefit to all members.

takeaways

- Retirement plan sponsors that are looking to increase retirement security for plan participants while controlling costs for employers may want to consider adopting an adjustable pension plan (APP).
- APP designs can improve the sustainability of multiemployer plans by encouraging new employers to join and limiting withdrawal liability.
- Two common types of APPs include (1) *variable annuity plans,* which adjust the entire accrued benefit that a participant has earned based on the plan's investment performance, and (2) *variable accrual plans,* which adjust only future benefit accruals to reflect changes in the plan's funded status and plan costs.
- Among the key design decisions when setting up an APP include whether the benefits will be entirely variable or will have a guaranteed floor.
- Plan sponsors also must consider how the plan will affect benefits for various age groups and whether transition benefits should be provided for older workers.
- The Newspaper Guild/Communications Workers International Pension Plan adopted a variable accrual style of APP in 2016.

Variable Annuity Plan

The advantage of a variable annuity plan is that participants may receive higher than the guaranteed floor benefits when the plan's investments earn between, for example, a 5.5% discount rate, also called the *hurdle rate,* and a 10% cap. The plan has a built-in reserve that accumulates when the fund earns returns above the cap. The surplus is set aside and used to minimize benefit reductions when investment returns are down.

To set up such a plan, actuaries perform an actuarial valuation using a conservative discount rate, typically between 5% and 6%, to determine what benefit level can be supported. The discount rate can be thought of as the expected return on assets over the long term. Developing a plan based on a lower than usual discount rate allows the trustees to adopt a conservative asset allocation.

To calculate the benefit that participants earn in a year, the benefit accrual is divided by the share value for that year to arrive at the number of shares earned during the year. The number of shares accumulates each year as participants earn additional years of service throughout their career.

The plan's investment performance is compared with the hurdle rate each year. The share value is adjusted each year by the following factor:

$$\frac{(1 + \text{investment return})}{(1+ \text{hurdle rate})}$$

If the plan's investment return is 7% for a year and the hurdle rate is 5%, then the share value would increase by 1.019 (1.07 divided by 1.05). If the plan starts with a share value of $10.00, the following year's share value would be $10.19.

The benefit payable is then equal to the number of shares a participant has earned multiplied by the share value. As the share value changes each year, so will the amount paid to participants.

This type of APP offers several features:

- Participants may convert to a fixed annuity at retirement; however, this will eliminate the potential for the plan to protect the participants' fixed lifetime annuity from eroding due to inflation. Of course, a steady source of income makes it easier for retirees to budget.
- Participants may receive a guaranteed floor benefit to protect them in the event of a severe downturn in the market.
- Some plans have a stabilization reserve to protect benefits from decreasing.
- The plan may use a cap on the investment return rate so that any returns higher than the cap are excluded from the share value calculation. This will help build up a reserve and increase the funding percentage of the plan.

One example of a plan that opted for an APP instead of a DC plan is the Greater Boston Hospitality Employers Local 26. The fund adopted a variable annuity plan in 2012. Union officials were worried because only 20% of the union's 4,000 members were contribut-

ing to the 401(k) plan, putting them at risk for not having enough savings for a secure retirement.

Union officials wanted a plan that would protect participants against longevity risk and from shouldering all the investment risk. Participating employers, however, worried about the cost of switching from a DC to a DB plan, volatile contribution requirements and the likelihood of an underfunded plan.

The fund decided on a design that would guarantee participants a floor benefit—even if the plan's investments earned less than expected—with upside potential depending on investment returns. At retirement, participants would receive a fixed annuity for life.

Variable Accrual Plan

The second type of APP design adjusts future benefit accruals rather than the value of the accrued benefit. Participants' previously accrued benefits do not fluctuate. The plan adjusts future benefits based on the expected funded level and cost of the plan for the upcoming year. When the plan is more than 100% funded—or more if a higher target is desired—the surplus may be used to increase future benefits.

With the variable accrual plan, the employer contributes a fixed amount annually. This can be expressed as a fixed percentage of payroll or employer budget. If the plan's funded status improves year over year and exceeds the target, benefit accruals will increase the following year. If the funded status declines below the target, benefit accruals for the upcoming year will be reduced to allow more of the contributions to go toward shoring up the fund.

The advantage of this design for participants is that it is similar to a traditional DB plan because accrued benefits do not fluctuate in value due to market volatility, and the plan takes a proactive approach to making up any shortfall. Many employers like this design since its cost structure is like a 401(k) plan in that it provides funding stability and allows them to more easily budget upcoming costs. While plan trustees may amend or modify plan

bios

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terms, the plan automatically adjusts future benefit accrual rates so that trustees do not incur the expenses of amending the plan each year.

Variable Accrual Plan Case Study

By 2015, the Newspaper Guild/Communications Workers of America International Pension Plan, a plan that primarily represents journalists and media workers, was in financial trouble and headed toward insolvency. The plan was projected to be only 30% funded within 20 years.

Even after reducing benefits and removing all adjustable benefits, the plan determined that participating employers would need to increase contributions year after year by 6%, putting them in an untenable position.

The Pension Protection Act requires critical and declining or failing multiemployer plans to review their rehabilitation plans periodically. In 2015, after reviewing options, the plan trustees agreed that they needed to make changes in order to discourage existing employers from withdrawing from the plan. Among the choices they faced were applying for permission from the Treasury Department to cut benefits and undertake a partition under the Multiemployer Pension Reform Act (MPRA) or merging with another plan as permitted by the law.

But these options would result in considerable pain for both participants and participating employers or were judged to be otherwise unattainable.

So, trustees considered another option—one that would later be described as "an attractive alternative to a struggling defined benefit plan," by the *Guild Reporter* newsletter in 2017. That option was to set up a new APP for future accruals while freezing accruals under the existing pension plan.

The Guild newsletter described the advantages of an APP to participants compared with a traditional DB plan: "Defined benefit plans have the potential for larger payments to retirees when the economy is humming along, but when the economy tanks, these plans often suffer large losses. This can result in much lower than promised monthly benefits for retirees or necessitate large payments by employers to prop up funding."

The variable accrual plan, in contrast, would provide retirement income security to plan participants through annual accrued benefits while meeting the concerns of existing employers about unfunded liabilities.

The plan was designed so that the projected funded status of the frozen legacy pension plan would be in a similar funded position as before the changes. Any excess contributions are redirected into the new NewsGuild-CWA Adjustable Pension Plan (NewsGuild-CWA APP). The objectives of the new plan are to ensure predictability of contributions for employers and to ensure a secure, predictable, lifetime pension for participants. Future accruals for participants vary annually depending on investment returns and the expected cost in a particular year. At retirement, participants get a fixed annuity, unlike other APPs that vary the pension as well.

The expected cost is based on the estimated valuation results before the beginning of the year. The plan adjusts the benefit accrual rate so that the expected contributions equal the expected cost of benefits accruing in the year, plus administrative expenses and amortization of any unfunded liability or surplus.

APPs take on lower risk than traditional pension plans and typically assume a lower discount rate. In the case of the NewsGuild-CWA APP, the discount rate drops from 5.5% for active employees to 3.5% when participants retire, a derisking strategy that ensures retiree liability is immunized. To further protect the APP from vagaries of the market, the plan is designed to be at least 105% funded and to amortize all the gains or losses over an accelerated ten years instead of 15 years as required by the Employee Retirement Income Security Act (ERISA).

Five years since the plan became effective in January 2016, the trustees are excited for what lies ahead. The plan is more than 150% funded and the accrual rate has substantially increased over its initial level in 2016. The plan is being actively marketed to new employers both within and outside the media industry. As the plan's participation grows, the accrual rate is expected to continue to increase for all participants because of economies of scale.

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