Realigning Retirement Benefits for a Transitioning Workforce

Employers must strike the right balance in providing benefits that are valuable and attractive enough to manage an orderly succession and turnover of their workforce while also achieving greater control in the management of costs and long-term commitments. This article describes changes in the retirement benefits landscape, the importance of understanding how today’s employees perceive their benefits, risk shifting under defined contribution (DC) plans and how DC plans can be “pensionized” in order to provide successful outcomes for participants. The author also discusses funding nonqualified retiree benefits such as employer-paid retiree life insurance, executive benefits, deferred compensation and employer-paid retiree medical. Employers that understand these issues and options will be able to implement a retirement benefits strategy designed for future generations while preserving commitments made to legacy workers.

by Tim Brown | MetLife

Retirement benefits play a key role in talent acquisition, development, attrition/turnover management and succession planning for many successful organizations. Cultivating workplace talent while controlling costs are two essential corporate objectives that often share a precarious path. Historically, talent objectives were achieved, in large part, through a robust lineup of employer-paid retirement benefits. But, amidst high costs and increased balance sheet sensitivities, many organizations have begun to scale back by freezing, reducing or limiting their expensive promises of the past in favor of retirement benefits that transfer more of the responsibility and ownership for achieving a financially secure retirement onto the shoulders of workers. The latter is likely better suited to today’s more independent and mobile employee just entering the workforce with a longer retirement planning horizon.

With this transitioning benefits model, those who manage workplace retirement benefits—including qualified plans, such as defined benefit (DB) and defined contribution (DC) plans, and even nonqualified benefits such as retiree life insurance, medical, executive benefits and deferred compensation programs—have yet another challenge to consider. They must grapple with fulfilling promises to their legacy workforce while seeking to creatively fund and finance attractive
benefit offerings in ways that will facilitate an orderly transition to retirement for current workers and the workforce of tomorrow.

Key for considering whether an organization can or should continue to offer and/or fund qualified and non-qualified retirement benefits is an understanding of the business value and costs associated with such programs, as well as considerations for how to best manage benefit liabilities, cash flow requirements and other financial impacts connected with these offerings. This article explores some of the spectrum of retirement benefit features and funding and financing solutions available today to help corporations achieve their talent objectives while also ensuring their workers are best positioned to achieve financial security.

Corporations must manage talent succession by striking the right balance between managing an orderly transition to retirement and fulfilling promises of the past while also providing cost-effective benefits of value that are attractive enough to allow today’s workers to plan for their future. In order to understand the important role that employer-sponsored benefits continue to play and how best to manage them, it is important to recognize how they are viewed (and valued) by workers. At companies of all sizes, a significant number of employees consider workplace benefits to be the foundation of their financial safety nets. These numbers rise as the size of the company increases. Many employees rely on the workplace for a majority of their financial needs and show their appreciation through loyalty.

Employees who cannot find financial security with their current employer might look for it elsewhere. Or, depending on their circumstances and the economic climate, they will stay where they are—possibly well past their most productive years. Workers who don’t feel that a secure retirement awaits them often stay in the workforce too long and pose a potentially serious threat to the health of the organization by impeding an orderly transition of the workforce and preventing employers from developing a robust transfer of knowledge and next-generation talent. Corporations must manage talent succession by striking the right balance between managing an orderly transition to retirement and fulfilling promises of the past while also providing cost-effective benefits of value that are attractive enough to allow today’s workers to plan for their future.

Retirement Benefits in Transition

Although most employers’ commitment to benefit programs remains strong, the rise of a more transient workforce has resulted in the benefits landscape changing in a number of ways. Workers spending an entire career with one employer used to be the norm, but the average worker now entering the workforce may have 12-15 different employers throughout his or her career. Most notably in the benefits landscape, the shift from the DB to DC plan as the primary retirement plan is reflective of the reality of both transient workers and rising benefit liabilities.

Benefits in general have become more voluntary and contributory, and many corporations have limited, frozen or capped cost outlays or discontinued some other retiree benefits such as employer-paid retiree life and health insurance. As the American Benefits Council (ABC) noted in its 2020 Vision white paper, “[e]mployer engagement may vary in the future as some companies continue a more traditional plan sponsor role,” in which they closely manage plan funding and administration, “while others choose to facilitate workers’ ability to take more direct ownership of their benefits.” For the latter, employers will act as a “facilitator” by “empowering individuals to take more direct ownership of their benefits.”

How Employees Perceive Their Benefits

In order to understand the important role that employer-sponsored benefits continue to play and how best to manage them, it is important to recognize how they are viewed (and valued) by workers. At companies of all sizes, a significant number of employees consider workplace benefits to be the foundation of their financial safety nets. These numbers rise as the size of the company increases. Many employees rely on the workplace for a majority of their financial needs and show their appreciation through loyalty.

Employees who cannot find financial security with their current employer might look for it elsewhere. Or, depending on their circumstances and the economic climate, they will stay where they are—possibly well past their most productive years. Workers who don’t feel that a secure retirement awaits them often stay in the workforce too long and pose a potentially serious threat to the health of the organization by impeding an orderly transition of the workforce and preventing employers from developing a robust transfer of knowledge and next-generation talent. Corporations must manage talent succession by striking the right balance between managing an orderly transition to retirement and fulfilling promises of the past while also providing cost-effective benefits of value that are attractive enough to allow today’s workers to plan for their future.

Talent acquisition is now the third most important human capital challenge facing companies around the
globe—with 81% of 10,000 recently surveyed human resources and business leaders across 140 countries calling it important or very important. Employers have a significant opportunity to attract and retain key talent and facilitate the timely retirement of their workforce with a thoughtful combination of benefits throughout employees’ working years and into retirement. Benefits that continue beyond active employment, such as a small amount of employer-paid group term life insurance for final expenses, can be an integral and affordable part of that mix. According to one industry source, “...I think it’s time we throw away the word ‘retention.’ No employer can ‘retain’ anyone—we have to ‘continuously attract’ our own people. We like to think about creating a ‘magnetic’ workplace that ‘attracts’ people.”

**Transferring Defined Benefit Plan Liabilities**

DB pension plans, the bulwark of retirement security for many workers for so long, are a benefit that today is afforded to a dwindling few. Just 20% of Fortune 500® companies offer a DB plan to salaried new hires, down from 59% among the same employers in 1998. Against the backdrop of a challenging market and regulatory environment, some DB sponsors are employing pension risk management strategies to mitigate this liability.

Pension risk can be transferred from the company either to an individual through a lump-sum offer or to an insurer through the purchase of a group annuity contract. In the former, the plan removes pension risk from its balance sheet through a lump-sum payment to a participant, which settles any and all claims that the participant has under the plan. However, while a lump-sum approach may appear to be the most expeditious option for a sponsor, it may not be the most prudent for participants, since very few participants are equipped to manage the investment, market and longevity risks that are being transferred to them.

When accepting a lump-sum offer, participants waive the right to receive the benefit in the form of steady, predictable monthly income. Instead, they must manage the sum received—often more money than they have ever seen—so that it lasts for as long as they live, without knowing when that might be. The latest research shows that many participants who choose a lump sum will later regret their decision, since one in five (21%) will deplete the money within 5½ years, on average.

When a company decides to transfer its pension risk by purchasing an annuity from an insurance company, the payment and administrative obligations, as well as the related risks, are transferred to the insurer. It does not represent a risk transfer to the participant in any way but does facilitate the ability of a sponsor to responsibly reduce its pension plan risk. For participants, the only thing that changes is the entity from which they are receiving their retirement income payments.

By isolating and then transferring a portion—or all—of the pension risk to an insurer, plan sponsors may be able to take a big step toward reducing the volatility of their plan, improving funded status and restoring some stability to the company balance sheet. Derisking also provides companies greater flexibility to focus on core businesses.

There is no one point at which derisking should happen, since each company’s financial drivers, plan cash flows and accounting histories are different. It is recommended that plan sponsors evaluate costs and benefits, identify an acceptable cost level, secure the necessary agreements and monitor the environment and funded status in order to be in a position to act when the timing is right.
Pensionizing DC Plan Savings

The transition from DB to DC plans is a trend that began some 30 years ago. Although most plan sponsors adopted DC plans as a supplemental savings plan, today the 401(k), 403(b) and other DC plans may be the sole retirement plan offered by the employer. This has created a shift of responsibility for retirement onto plan participants who must determine—often largely on their own—how much to save for retirement, how much they can draw down from their savings in retirement and how long their money will need to last.

As with other types of voluntary benefit programs, DC plan sponsors and their providers may offer tools (e.g., automatic enrollment and escalation, education and communication) and other resources to empower employees with better financial and investment decision-making skills. However, due to a number of macroeconomic events—not the least of which was the Great Recession of 2008—results of the DC “experiment” are, thus far, mixed. Not only are many DC participants woefully underfunded for a three- or four-decade retirement, those who have amassed a sufficient amount typically have no idea how to translate those savings into sustainable, predictable retirement income. For many active workers and those already retired, the fear of running out of money has become all-consuming—and justifiably so, since the ability to live off a lump-sum distribution is as difficult and risky for DC participants as it is for those who take a lump sum from a DB plan.

Unfortunately, the shift from DB to DC also did away with a critical participant benefit—the promise of lifetime income. It has taken a generation of difficult lessons for stakeholders to return to the DC drawing board to address the crucial importance of guaranteed income as a core component of a retirement plan. Indeed, many are now meeting the 401(k) retirement income challenges with a sense of urgency, because low savings balances, increased longevity and pressure on Social Security are not just problems for employees. When the workforce can’t make a smooth transition to retirement because of the absence of a predictable, monthly paycheck to cover expenses, the employer suffers too.

The retirement industry, and insurers specifically, are lobbying to extend to DC plan participants opportunities comparable with the DB promise of a secure financial future. Guaranteed income products designed and priced specifically for the institutional DC plan are already on the market and can be added by plan sponsors for use by participants to ensure a safe, predictable income with monthly benefits that begin as early as the age of 65 (or earlier if the plan allows) or as late as the age of 85.

Much has been accomplished in educating participants on the risks and opportunities of systematic drawdown strategies (also called SWiPs) and managed accounts and how these can be effectively used in conjunction with annuities. In addition, legislation has been introduced that would pave the way for lifetime income disclosures on DC plan account statements and provide sponsors more clarity on applying the safe harbor for the selection of an annuity provider. But there is still more that must be achieved. Whether through guaranteed income (annuity) options designed to complement the DC model or through broader financial wellness outreach and solutions, or both, DC plans must provide more successful outcomes for today’s participants, and lifelong income should be the outcome of these plans.

Funding Other Retiree Benefits

In addition to DB and DC plans, many larger employers offer nonqualified benefits such as postretirement life insurance, deferred compensation, supplemental executive retirement plans and postretirement medical benefits. The value
of these benefits is most appreciated by key, experienced talent and workers closer to retirement and can be useful in both attracting and retaining highly skilled, more experienced employees. However, they also can create benefit liability concerns down the road for the corporation, which has led many employers to reevaluate the pros and cons of these types of retirement benefits.

Market volatility in recent years has highlighted employees’ concerns about their financial security during retirement. For many, benefits provided by their employer may be their primary source for protection and financial security, even in retirement. Without these employer-paid or subsidized benefits, the loss of a paycheck, combined with inadequate savings and the responsibility of shouldering the full cost of health and life insurance protection, may make it financially inconceivable for employees to retire. Thus, once again, the employer may be impacted by an unhealthy rate of worker attrition as older workers delay retirement.

This is why having a financially efficient liability management strategy in place and supported by other nontraditional funding/financing mechanisms is more important than ever. Generally, these types of benefit liabilities are accumulated over years. Fortunately, there are strategies that employers can prepare in advance and deploy over time to strengthen the financial viability of fulfilling implied promises of future benefits made to employees concerning many welfare retirement benefits, such as medical, dental and life insurance.

**Employer-Paid Retiree Life Insurance**

Unlike pension liabilities, employers are not required to prefund nonqualified benefits, but there are significant benefits in doing so—particularly related to retiree group term life insurance. For example, within certain limits, employers that prefund retiree group term life insurance can benefit from accelerated tax deductions and tax-free earnings (while continuing income tax-free proceeds to beneficiaries). They also can strengthen financial statements and achieve greater budgeting and financial flexibility.

Group term life insurance is one of the most cost-effective retirement benefits that employers can offer to ease the financial burden for retirees and their families for final expenses. In addition to being relatively inexpensive, it is easy to manage compared with other retirement welfare benefits. Strategies to manage liabilities arising from employer-paid retiree group term life obligations include funding these liabilities or a buyout that transfers the obligation to an insurer (similar to a pension risk transfer) and can be valuable in managing long-term costs. But funding nonqualified retiree benefits is very different from funding a pension plan. Nonqualified benefits generally require their own cash flow analysis since the costs associated with these programs increase as the ratio of retirees to active employees in the plan rises, and the average age rises as retirees live longer.

Through the use of products specifically designed for funding employer retiree group term life liabilities or transferring risks of these liabilities, employers can achieve the benefits noted above. It must be emphasized, however, that not all products are the same. Therefore, in evaluating such products and options currently in the market, employers should fully understand and carefully consider any associated tax, Employee Retirement Income Security Act, accounting and/or other potential impacts to both the corporation and participants. Although funding retiree group term life insurance liabilities is voluntary, as previously noted, a formal funding and/or risk transfer for accounting settlement of this type of liability can be achieved, including accelerating corporate tax deductions within certain limits while preserving the favorable tax treatment of this benefit for participants.

**Executive Benefits, Deferred Compensation and Employer-Paid Retiree Medical**

Unlike retiree group term life insurance liabilities, where it may be relatively simple to implement a voluntary formal funding plan, informal funding tends to be the most common and well-established means of setting aside assets for other particular types of nonqualified liabilities. Whether combined with a trust, such as a voluntary employee beneficiary association (VEBA) trust, or a rabbi trust or held directly by the employer, corporate-owned life insurance (COLI) is generally a popular choice.

COLI is a type of life insurance contract owned by an employer that insures the lives of one or more employees, typ-
ically at director level and above, where the employer has an insurable interest and the employee consents to purchase by the employer. COLI can be used, for example, as key-person life insurance to mitigate financial losses for the business in the event of the death of a key employee.

Employers also use COLI policies to informally fund nonqualified benefit liabilities, since both the cash value and death benefits may provide greater capital efficiency, flexibility and yield on a posttax basis than other assets directly purchased by the corporation or trust. Informal funding via COLI is particularly prevalent with banks and other financial institutions that are highly capital- and balance sheet-sensitive, since it’s an efficient asset/liability management tool that can positively impact a company’s overall financial statement. COLI best practices were codified in the Pension Protection Act of 2006—an acknowledgement of the important contribution COLI makes in funding these types of nonqualified benefits.

Conclusion

Implementing a retirement benefits strategy designed for future generations while preserving commitments made to legacy workers is a particularly complex undertaking and one where the delicate balance between retirement benefits offered and the traditional mechanisms used to fund them can shift at any time. Employers must strike the right balance in providing benefits that are of value and attractive enough to manage an orderly succession and turnover of their workforce while also achieving greater control in the management of costs and long-term commitments. This balance is one that most organizations are committed to preserving, to the extent possible, because these programs play a critical role in their human capital strategy—and ultimately in their ability to compete. The way in which retirement benefits are deployed and managed, coupled with public policy that allows for flexibility in plan design, can greatly impact the extent to which retiring workers enjoy a secure future.

Endnotes


Reprinted from the First Quarter 2018 issue of BENEFITS QUARTERLY, published by the International Society of Certified Employee Benefit Specialists. With the exception of official Society announcements, the opinions given in articles are those of the authors. The International Society of Certified Employee Benefit Specialists disclaims responsibility for views expressed and statements made in articles published. No further transmission or electronic distribution of this material is permitted without permission. Subscription information can be found at iscebs.org.

©2017 International Society of Certified Employee Benefit Specialists