Viewpoint

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Defined Ambition Plans – the Best of Both Worlds

Third in a series

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In the first two articles on the proposed new design called the Defined Ambition ("DA") plan, we explored a rationale for a new retirement model and outlined how it might actually work. In this article, we will list the "best of both worlds" characteristics that are carried over to this new plan design.

For purposes of the article, we have simplified the new retirement model by eliminating all the benefit guarantees that plan participants currently have in Defined Benefit ("DB") plans. In large part, these benefit guarantees don't exist in Defined Contribution ("DC") plans and plan participants have come to accept that element of risk. Of course, if DA plans were to be enabled by legislation in the U.S., it is possible that the statutory structure may require some guarantees (because Government always knows what's good for you). My preference would be to have no statutorily-mandated guarantees but to allow individual employers to write some limited guarantees into their own plans, if – and to the extent that – they wish to do so.

Pension Plan Characteristics to Transfer to New DA Retirement Model

Let's list the DB plan characteristics that would transfer over to the new retirement model.

1. Benefits would usually be payable in an annuity form (unless the plan structure mirrors a cash balance plan), thereby resulting in lifetime benefits. However, in its purest form, the employer does not bear the longevity risk in this new retirement model. The longevity risk is, instead, borne by all the participants in the DA plan.
2. Benefits could be based on final average compensation as in a final pay DB plan. In its purest form, the employer does not bear the salary increase risk for the participant group as a whole, either. Again, this risk is borne by all the participants in the DA plan. While corporate interest in a final pay DB plan may be revived, it does not rule out career-average or cash balance or any other kind of pension plan design currently available or contemplated.
3. Investments could be handled by professional managers in a cost-efficient manner in order to maximize return within fiduciary guidelines. Here, too, in its purest and likeliest form, the employer does not bear any of the investment risk. The employer can avoid fiduciary risk by meeting certain fiduciary standards.
4. Accrual of benefits would follow the "DB" pattern – in a traditional final pay plan, the DB accrual is heavily weighted towards the later years. This pattern "matches" the pattern of employee awareness of their retirement needs and their focus on their emerging retirement benefits.

Defined Contribution Plan Characteristics to Transfer to New DA Retirement Model

Now let's list the DC plan characteristics that would transfer over to the DA plan.

1. The employer would have a contribution amount determined in advance for the benefit accrual that the new retirement model "aspires" to provide.
2. The amount charged to income (i.e., the expense) in the corporate financials is equal to the cash contribution amount.
3. There is no "legacy" cost that the employer has to make up for an underfunded plan. Any additional contribution made by the employer for a plan that's falling behind its "aspirational" benefits is totally voluntary and, if any are made, they would be at the level set by the employer.
4. Underperformance of plan investments would reduce the DA plan benefits just like investments affect DC plan account balances.

We have described what happens in the "purest form" of the DA plan. There are an infinite number of ways to have the employer share some of the risk with the employees. But, it may be easier to start the analysis with a "pure" DA plan, where all the risk is taken by the participants (and shared among them). After all, the retirement industry has managed to pass even greater risk to participants through the DC plan, including risks that become apparent only during the de-accumulation phase.

Is the DA plan a perfect solution? Maybe or maybe not. At the very least, though, it brings some of the "best" DB plan features to complement some of the "best" DC plan characteristics. Let the conversation continue.