Viewpoint

September 19, 2013

Is it Time for A New Retirement Model?

By Neville Arjani

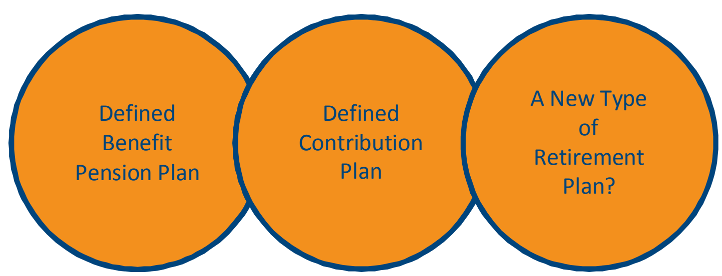
In the U.S., defined benefit pension plans are increasingly being replaced by defined contribution plans. The primary reason for this is the combination of economic and business forces that have made defined benefit plans too risky for many companies. Today, employers are reluctant to make benefit promises without clear-cut limitations on the size of contributions that they would need to make. The relative weakness of the equity market since the turn of this century has resulted in a volatile and costly ride for employers as they struggle to make good on their retirement plan obligation to employees. Additionally, new funding rules require that defined benefit pension plans that are underfunded must make up their funding deficiency over a brief time span. Many corporations have been scared off by the accounting standards' fixation on marking assets and liabilities to "market," as they cannot afford this kind of volatility on their balance sheets and income statements.

Defined Contribution Plans

As the name implies, a defined contribution plan defines the employer's retirement contribution to its employees. The performance and volatility of the plan's investments is a risk that the individual participant must bear and, as a result, the employer limits its obligations in terms of the retirement plan contribution amount. This gives employers an exact picture of their financial commitment to each plan. For better or for worse, the predominance of this type of plan is a reality in our country today.

Another reality that is becoming increasingly evident is uncertainty regarding the length of time over which retirement payments can be derived, before their accounts are exhausted. With the large number of baby boomers entering their retirement years, a whole cottage industry is springing up to help hapless senior citizens draw down their retirement accounts.

One of the key deficiencies of the current defined contribution plan structure is the absence of a lifetime annuity benefit, except where this is done by purchasing an annuity from an insurance company. On the other hand, a defined benefit pension plan transfers this risk onto employers' shoulders by taking on the promise of a lifetime annuity. Employers are left to bear the risk/reward of investment performance as well as the risk of longevity as life expectancies continue to grow. Defined contribution plans rid employers of both these risks; however, in so doing, they pass them on to employees and retirees. This begs the question of whether or not a lifetime annuity benefit similar to that provided by a defined benefit plan could be secured through an entirely new type of retirement plan.



A Better Mouse-Trap

Wouldn't it be nice to create a defined contribution plan that provides an actuarially-determined lifetime annuity benefit in a cost-effective manner – without incurring the costs, margins and low investment returns that often go with an annuity purchase from an insurance company? Currently, only a few defined contribution plans provide a lifetime annuity option through these insurance company annuities. Even then, fewer retiring employees – given the choice – actually select an insurance-purchased payout. How about making the lifetime benefit a fundamental component of this new defined contribution plan design without the employer bearing some of any of the risk associated with longevity?

The defined benefit plan has lost favor because it does not place caps on employer costs. Unfavorable investment, longevity, or other plan experience can result in the employer paying wildly swinging costs for "legacy" benefits. In today's competitive business market along with the chronically weak economic environment, few employers wish to live with the punitive funding rules and accounting standards that defined benefit plans are subject to. A new type of plan that combines many of the virtues of defined benefit and defined contribution plans would require enabling legislation; it's high time for this kind of "out-of-the-box" thinking. In this brief article, we did not elaborate on the intricacies of this kind of defined contribution plan. Further, there can be variations of the basic design. Please let us know if you like this type of design or want to know more about how this kind of plan could work in practice.