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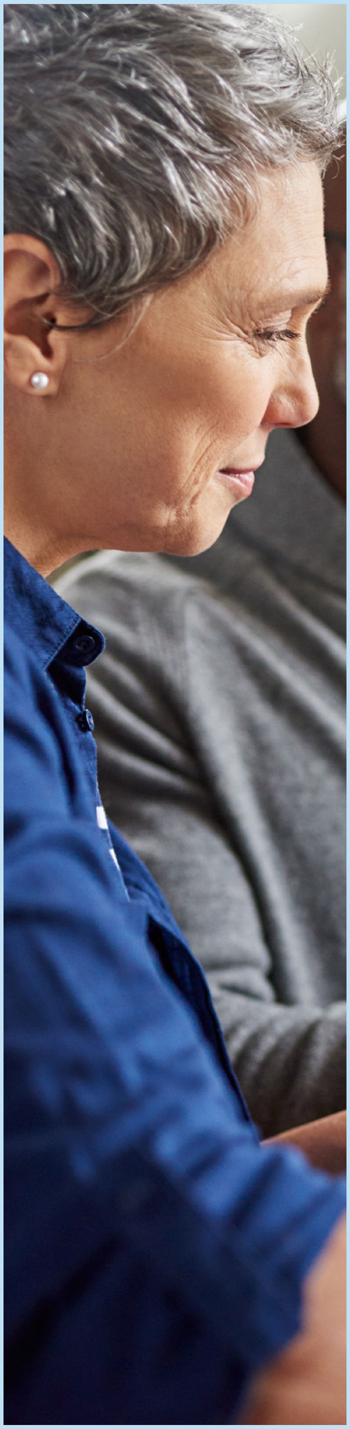

REINVENTING THE RETIREMENT LANDSCAPE WITH HYBRID PENSION PLANS

Abstract

Today, with people living longer, rising healthcare costs, and poor savings culture, retirement is a looming crisis for most. Moreover, employers moving away from offering guaranteed retiral benefits have mostly shifted to defined contribution plans. Considering the importance of a secure retirement and the magnitude of the problem, all stakeholders are responsible for actively working towards a solution. In this context, hybrid pension plans can emerge as a game changer, tackling many challenges of the current crisis, right from savings motivation to retiral income. Additionally, the composition and rules of such a hybrid pension plan are paramount to achieve success. This paper discusses a 'golden rules' driven hybrid pension plan which guarantees benefits that are not only progressive but also contingent on defined contributions.

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The realities of retirement

These days, successful retirement appears out of reach for most Americans. The data points to some scary ground realities. According to a National Institute on Retirement Security research report, over 100 million working-age individuals in the US do not own any retirement account assets, whether in an employer-sponsored 401(k) type plan or an IRA, nor are they covered by defined benefit (DB) pensions. About 66% of millennials — despite their utmost concern about retirement security, and are more willing than other generations to save more — have absolutely nothing saved up for retirement. Almost half the pre-retirees have zero amounts in retirement savings. Also, as per the 2019 IBISWorld research report, the retirement & pension plans in the US industry has declined by 14.4% over the last five years, and many pension plans are underfunded.

Over the last two decades, employers have smartly offloaded their long-term retirement planning obligations to employees. As a result, defined benefit (DB) plans with their guaranteed retirement benefits have mostly been replaced by defined contribution (DC) plans. Concurrently, with the decades-long American wage stagnation, the scarce skills and knowledge on retirement planning among individuals, and their poor financial discipline, the retirement problem has only deepened over the years and is on the verge of becoming a systemic crisis.

The shared responsibility of retirement security

Influenced perhaps by cultural shifts and the nuclearization of families over the last few decades in the US, retirement planning is somehow seen as a matter of individual responsibility. Employers have also been keen to offload their burdens related to pension costs and liabilities onto employees. The repercussions are now in front of us. The transfer of responsibility has not worked at all due to various reasons, and the retirement problem is far more complicated than ever before.

In the long term, this problem impacts not only individuals but also the economy. If retirees do not have adequate means of survival, they will be a burden on society and the economy. Therefore, the industry needs to become stakeholders in retirement responsibilities right in the initial phase, before it becomes a crisis and a burden. At the same time, this responsibility must be shared with the other stakeholders, namely employees, who need to work together towards a solution for secured retirement with guaranteed retiral benefits.

The optimal shape of retirement income

Broadly, the three pillars of retirement are social security benefits, personal savings, and income from defined benefits (DB) or defined contributions (DC) plans. In an ideal model for a typical individual, we expect each of these three pillars to provide one-third of retirement income.

Social security benefits are not very substantial and there are concerns relating to the funding gap. Yet, it remains the single most significant source of income for most US retirees and has the capacity to provide one-third of retirement income for them.

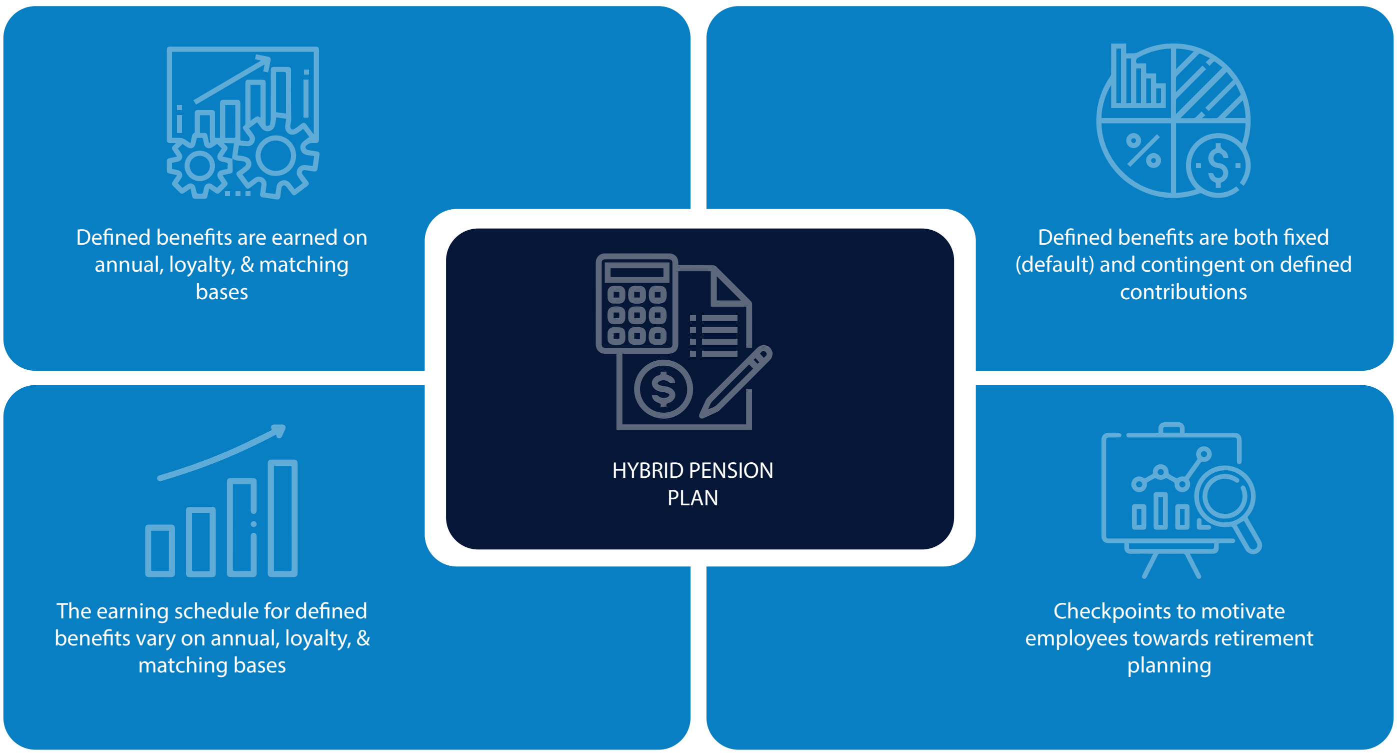
On the personal savings front, the current savings culture needs improvement with the active collaboration of all stakeholders. Individuals need to understand the benefits of saving and the power of compounding before they can adopt a savings culture.

Moving to the last pillar of retirement income, the current imbalance between DB and DC plans is unfair to employees by making them solely responsible for their retirement planning and income. According to a 2019 National Institute on Retirement Security more than 61% of employees are willing to forgo some pay over guaranteed retiral benefits. In general, more than 75% of US nationals are attracted to defined benefits pension. Even millennials cherish pensions over 401(k) DC plans.

This situation, where over half the employees are willing to buy guaranteed retirement income at the cost of their savings, demands a hybrid pension model composed of DB and DC that can provide guaranteed retiral benefits. With such a model, retirement responsibility can be actively shared between employers and employees. The DB component that is contingent on participation in DC plans, can motivate employees to save for their retirement. Furthermore, this contingency should be designed to operate at multiple levels to impact the overall culture of retirement planning.

The hybrid pension plan - a proposed design

The hybrid plan outlined below, with both DB and DC components has four major structural concepts.



1. Employees earn defined benefits on annual, loyalty, and matching bases. Therefore, in addition to yearly credits towards defined benefits, additional loyalty benefits are provided after every X years of service. Employers can specify their own credit rules, but the idea is to encourage employee loyalty. Matching DB credits add another layer of motivation and will bridge the gap between defined contributions and defined benefits over the period. By design, it will be credited on a surprise basis to match the defined benefits to defined contributions in any given year but will also equalize periodically.
2. All the yearly or loyalty based defined benefits should not be available by default, except for a small percentage of the credits. Afterward, an employee is required to make threshold contributions in DC plans to become eligible for the rest of the DB credits. A contingency-based model would not be advisable for matching DB benefits.
3. Different credit schedules must be defined for the defined benefits linked to the annual, loyalty, and matching bases. This will keep employees continuously involved.
4. Multiple checkpoints must be included to encourage and motivate employees to make the required defined contributions so that they save enough for their retirement. When a sizeable portion of defined benefits is contingent on employee's defined contributions, employees will be inclined towards making defined contributions to earn DB credits.

The three tables below illustrate the conceptual schedule of DB credits under yearly, loyalty, and matching bases. These schedules are for illustration purposes only, and employers are expected to come with their own benefit credit schedules. Here, 'credit units' are used to measure contributions and benefits. As an example, when defined benefits are contingent under the 'loyalty' scenario, only 1.00 DB credit will be available by default after completing of 20 years of service. However, an additional 3.50 DB credits will be available to the employee after making 5.0 units of defined contributions. The proposed model does not comment on vesting of benefits, considering this as a standard ongoing market practice.

Note that only limited DB credits are available to employees by default on yearly and loyalty bases, but more benefits are contingently available, and employees can earn them by making required defined contributions. Moreover, these benefits are also progressive and become significant in the later years of employment.

Furthermore, matching credits start equalizing after ten years of service, but employees can potentially earn them earlier also. Any unearned defined benefit will accumulate in the equalization year. Additionally, different DB credit schedules for the yearly, loyalty and matching bases make the hybrid pension model more inclusive for employees, as benefits are due frequently with shorter wait times.

Annual Credits for Default and Contingent Defined Benefits

Age of Service (Range)	Default DB Credits	Required DC Contributions	Contingent DB Credits	Total DB Credits
01-05	0.50	1.00	0.50	1.00
06-15	0.55	1.20	0.60	1.15
16-25	0.63	1.56	0.78	1.41
26-40	0.76	2.18	1.09	1.85
40-50	0.95	3.27	1.63	2.58

Schedule of Loyalty Credits for Default and Contingent Defined Benefits

Age of Service	Loyalty Deafult Credits	Required DC Contributions	Loyalty Contingent Credits	Total DB Credits
5	0.50	1.00	0.50	1.00
10	0.60	2.60	1.25	1.85
20	1.00	5.00	3.50	4.50
30	2.00	8.00	5.00	7.00
40	2.50	10.00	7.00	9.50
50	3.00	11.00	8.00	11.00

Schedule of Matching Credits for Defined Benefits

Age of Service	Total DB Credits	Required DC Contributions	Required Matching DB Credits	Delta DB Credits (if Unearned)
10	13.60	14.60	1.00	1.00
15	19.35	20.60	1.25	0.25
20	30.90	33.40	2.50	1.25
25	37.95	41.20	3.25	0.75
30	54.20	60.10	5.90	2.65
40	82.20	91.90	9.70	3.80
50	119.00	135.60	16.60	6.90

The inevitable success of hybrid plans

Having seen the structure of the newly proposed hybrid pension scheme, there is now the obvious question on its effectiveness. In the context of the expanding retirement crisis, how much of a positive change can it bring? Also, how will employers respond considering that they need to participate both financially and operationally?

At this juncture, when the retirement problem is only deepening, and many employees display a strong preference towards pension — even at the cost of some pay — employers will eventually have to align with DB plans to meet the needs of their workforce. Several case studies have indicated a large negative impact on employers who have shifted from DB to DC pension plans, with some eventually forced to return to DB plans.

For now, due to the purely theoretical nature of hybrid pensions, their retirement reinvention quotients (RRQ) are difficult to quantify. However, considering their prospective benefits, and their perspective of retirement as a shared responsibility of all stakeholders, hybrid pensions are expected to be a game-changer as they will directly address the root of the retirement problem.

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