

CLIENT BULLETIN

Alternative Pension Plan Designs

In [Client Bulletin 2016-51](#) we looked at proposed legislation allowing the creation of “composite plans” as an alternative to the traditional defined benefit (DB) or defined contribution (DC) plan. A composite plan is a *new type of multiemployer retirement plan* that is neither a traditional DB plan nor a DC plan. For now, the proposed legislation is in limbo. If it begins to move, we will report on such progress.

In this Bulletin, we will look at the composite plan concept, as well as other alternative retirement plan designs. Some of these alternative designs include:

- Cash Balance Plan
- Variable Defined Benefit (VDB) Plan
 - ◆ With/Without Floor or Cap
 - ◆ Stabilized VDB

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We will first take a brief look at Composite Plans. More detailed information can be found in [Client Bulletin 2016-51](#). *We will be describing the alternative options in broad strokes.* The mechanics of transitioning to an alternative plan design are beyond the scope of this Bulletin.

Composite Plans

A composite plan combines the flexibility and certainty of a 401(k)-style DC plan with the lifetime income provided by a DB pension plan. The contribution is more of a certainty because the composite plan will never have employer withdrawal liability (EWL). The composite plan also is not insured by the PBGC, so there are neither PBGC premiums nor premium increases to worry about.

Composite plans will be professionally managed, and benefits will be provided in the form of annuities. The trustees managing the composite plan will set benefit levels based on incoming contributions and conservative funding requirements. If the plan

is not expected to be 120% funded in 15 years, the plan will be required to implement a realignment program that may include contribution increases, benefit accrual decreases and benefit adjustments. These strict funding requirements are designed to ensure composite plans are able to weather any challenges they might face, considering there are no funding backstops from EWL or PBGC insurance.

The proposal will ensure that existing multiemployer pension plans, also known as legacy plans, are sufficiently funded. A "legacy plan" is the original DB plan that existed before the adoption of a "composite plan." This will be true even for employers and unions who choose to transition to new composite plans. Employers who contribute to a composite plan will be required to fund existing multiemployer pension commitments.

In addition to having no EWL, contributions to a composite plan are not taken into consideration when determining EWL with respect to the legacy plan. A legacy plan is deemed to have no unfunded vested benefits if a plan is fully funded under PBGC's "mass withdrawal" requirements, had no unfunded vested benefits for three of the last five years, and is projected to be fully funded for the next five years. To help ensure against volatile markets, tax-deductible contributions to the composite plan are allowed up to a 160% funded ratio.

Cash Balance Plans

Cash balance plans are fairly unusual in the multiemployer universe due to the emphasis placed on a lump sum form of benefit. However, we recently heard of a multiemployer plan choosing to adopt a cash balance plan design. Cash balance plans were discussed by the IRS in detail in an [article](#) as part of its **Employee Plans Continuing Professional Education Technical Instruction Program**. We will continue to paint with a broad brush, leaving the details for interested parties to ferret out.

A cash balance plan is a DB plan that *looks like* a DC plan. In general, participants have "hypothetical accounts" which will periodically increase due to employer contribution credits and investment credits. The investment return can be based on one of a number of permissible "market rate" options. At retirement, a participant can receive his account balance as a lump sum or convert it to an equivalent annuity.

The advantages of a cash balance plan are that it involves a sharing of investment risk; it has less volatility than a traditional plan and is generally easy to understand.

The disadvantages of a cash balance plan are that EWL is still possible, there is no benefit certainty for participants and it is still subject to PBGC premiums and coverage. For example, a legacy conversion (if elected) may cause initial increase in unfunded vested benefits, therefore increase EWL. In addition, a cash balance design does not provide any relief from the Pension Protection Act (PPA) zone rules, does not end EWL, and plans still must pay PBGC premiums. The IRS published [final cash balance](#) regulations in 2014.

Variable Defined Benefit (VDB) Plans

In a VDB plan, as the plan's assets and liabilities expand and contract due to market fluctuations. The VDB design preserves the funding of the plan in the event of a large market correction by reducing the participants' benefits. That is, participants still share in the plan's investment results (good and bad) by having their benefits adjusted to reflect economic reality. Unlike a DC plan, a VDB plan allows the pooling of longevity risk (members don't have to worry about outliving their money) and generally has a superior investment performance compared to DC plans.

VDBs have been permissible for decades but didn't catch on because benefits can drop, even after retirement and the design is not as easy to understand as a traditional DB design. Moreover, the VDB design can only apply to new benefits. Legacy plan benefits are frozen and must continue to be funded by contributing employers. VDBs provide no relief from the PPA zone rules or PBGC premium requirements. In spite of some of these negatives, the VDB design has attracted more attention due to the market volatility that plans have experienced these past 14 years or so. We will take a closer look at how the VDB design works and some variations of the basic VDB.

Some of the advantages of the stabilized VDB is that while benefits levels are *volatile* from year to year depending on investment return, benefits will increase when the return is above the hurdle rate. Further, changing market conditions do not affect *funding* of benefits and the plan's unfunded vested benefits (UVB) are virtually eliminated on the variable benefit piece. In addition, retired participants get some inflation protection (expected return > hurdle rate) and participants get an *immediate* bump from a great return year. Benefits are still pooled like a regular DB plan, so there is no worry of outliving the money as is possible in a DC plan when a lump sum benefit is taken. As in a traditional DB plan, plan assets are pooled and professionally managed.

The key disadvantage of the stabilized VDB is its complex design, which may be more difficult for participants to understand.

The IRS published [regulations](#) concerning VDBs in 2014.

How Does a VDB Plan Work?

A VDB plan typically sets a "hurdle rate" of 5%. If the plan out-performs the hurdle rate, benefits increase. If the plan is under-performing, benefits will decrease. In mathematical parlance, the benefit at the end of a year is equal to the benefit at start of year, times $(1 + \text{actual return}) / (1 + \text{hurdle rate})$ plus any benefits accrued during the year. This adjustment represents the "variable" part of a participant's benefit.

VDB Plan Variations

There are several variations of the basic VDB design. We discuss two below.

VDB Plan with a Benefit Floor

One variation to the typical VDB design involves adding a benefit floor below which benefits cannot be lowered and paying for it with a cap on the investment return applied to fund benefits, where the excess above the cap rate pays for the floor. The upside to a benefit floor is that it guarantees a benefit level to the participant; however, when the benefit level is above the floor, benefit volatility still exists as the benefit may need to be adjusted downward due to an inadequate investment return. The possible downside is that investment return above cap may never be needed and may be lost to the participant.

Stabilized VDB Plan

The stabilized VDB uses a “stabilization mechanism” to stabilize the participants’ benefit levels. This is done by creating a stabilization reserve from the benefit adjustments above the cap rate, which are not immediately applied to participants’ benefits. Instead, the stabilization reserve is applied in any year in pay status when participants’ benefits would have otherwise dropped below the highest benefit paid while in pay status. In other words, this design builds up a “cushion” from “above-cap” investment returns that can be used to soften the effect on participants in the event of any downward adjustment in benefits caused by “below-hurdle” investment returns. This allows participants’ benefits to be much more stable with significantly lower change of a benefit drop in retirement. This is the key advantage of the stabilized VDB design.

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