

Is there a better way to save for retirement?

Can  
**Stabilized**



*Variable  
Annuity  
Pensions  
Deliver?*

## Another Way to Build Retirement Wealth

For the first time in many years, there is a new retirement plan design that deserves serious consideration. The stabilized variable annuity pension plan is a pension plan (not an insurance product) that stays fully funded in all market conditions, has predictable contribution requirements and balance sheet stability, and provides lifelong, inflation protected income to retirees. It eliminates the difficulties of trying to get employees to contribute to their own retirement success and reduces workforce management issues that occur when too many participants retire in rising markets and too few retire in falling markets. In short, it is a retirement plan design that solves both the human resource and finance needs of plan sponsors, while providing retirement security for plan participants.

### How VAPPs Work

A basic variable annuity pension plan (VAPP) adjusts participants' benefits each year based on the plan's actual investment return. This has the effect of matching the liabilities to the assets each year, resulting in a plan that stays fully funded, regardless of investment performance or interest rate environment. However, when returns are poor, benefits are reduced for all participants, including retirees. Anecdotal information suggests that VAPPs were more prevalent in the 1950s and 1960s, but became less popular in the 1970s because of retiree dissatisfaction with unpredictable benefit declines. There are a number of these plans in operation today, but benefit volatility has remained a concern.

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### The Game Changer

On Sept. 19, 2014, the IRS issued regulations that allow for “stabilized” VAPPs. A stabilized VAPP functions much like a basic VAPP, but a portion of the investment return in good years is held back as a reserve to prevent retiree benefits from decreasing in bad years. In the unlikely event that the reserve is exhausted, benefits revert to the underlying (fully funded) benefits. The investment risk is still borne by the participants; they participate in the up markets, and the reserve functions like a savings account to protect against benefit declines in down markets.

The VAPP’s ability to stabilize both contributions and benefits allows plan sponsors to capture the strengths and avoid the pitfalls of both traditional defined benefit and defined contribution plans.

### DB Traditional Defined Benefit Plans



#### SPONSORS

Traditional defined benefit (DB) plans have been difficult for sponsors to manage over the past decade. The Pension Protection Act (PPA) funding requirements produce substantial contribution volatility compared with pre-PPA calculations. The ability to smooth assets has been reduced and liabilities now are

measured using bond yield curves which cause them to fluctuate from year to year. The combination of asset and liability volatility, coupled with the 2008 financial crisis, has made contribution requirements both large and variable. Consider the Milliman 100 companies (the 100 publicly traded companies with the largest DB plan assets in the United States). The combined contribution to their pension plans was \$12 billion in 2000. This quadrupled to \$57 billion in 2003, declined to \$28 billion by 2007, only to spike to \$62 billion after the 2008 financial crisis.

Not only does this volatility affect contribution requirements, it affects funded status. In aggregate, the Milliman 100 companies were more than 120 percent funded in 2000, but after a decade of large, volatile contributions, were under 90 percent funded in 2013. These same factors have produced balance sheet volatility and forming of the Pension Benefit Guarantee Corp. (PBGC) variable rate premiums.

In response to the requirement that sponsors measure liabilities with bond rates, there has been a significant movement to invest plan assets in fixed income to mitigate interest rate volatility. Between 2005 and 2013, the Milliman 100 plans reduced their equity allocation from 60 percent to 40 percent, while increasing their fixed income

allocation from 30 percent to 40 percent. This reduces return and funded status volatility but lowers anticipated returns as well, essentially trading lower contribution volatility for larger expected contributions.



#### PARTICIPANTS

Traditional DB plans do an excellent job of providing secure, stable retirement benefits to participants, assuming participants receive their benefit as an annuity rather than a lump sum. The benefit is guaranteed to be paid for life, ensuring that the participant, and spouse if desired, does not outlive assets.

There are two drawbacks to DB plans for participants. First, most private sector pension plans do not provide inflation protection on retiree benefits. During 30 years with 3 percent inflation, the purchasing power of a \$1,000 monthly benefit will have been reduced to \$412.

The other difficulty occurs for participants who leave a company midcareer. In retirement, their income may come from several plans. Because DB benefits do not generally adjust after termination, benefits earned early in their careers do not keep pace with inflation, ultimately producing smaller overall retirement income. For this reason, DB benefits are not considered “portable.”

### DC Defined Contribution Plans



#### SPONSORS

The stable, predictable contributions associated with a defined contribution (DC) plan are great for plan sponsors, at least on the financial side. When a DC plan is the primary retirement income for employees, however, human resource (HR) problems can arise. Retirement patterns can be driven by recent asset returns, which can result in workforce management problems.

According to a 2012 Towers Watson survey, there is evidence that younger workers view a company’s retirement plan as a significant factor

in accepting a job and they have an increasing preference for pension plans over DC plans. Pension plans also provide a retention tool for sponsors that DC plans do not. DC plans may be desirable from a financial perspective but may fall short at attracting and retaining top talent and encouraging orderly retirement from the workforce.



#### PARTICIPANTS

While DC plan participants do not face portability risk because their account balances are expected to continue to grow even if they terminate employment, they face all of the other major retirement risks alone. They have to manage their money — navigating investment, interest rate, and inflation risks. Consequently, they are likely to get smaller returns over time than professional asset management would.

Perhaps the most challenging risk for an individual to manage is longevity. Not knowing how long one is going to live makes retirement planning often difficult. If people manage their money to last to life expectancy, they have a 50 percent chance of outliving their assets. People managing their money to last until age 98 may still have as much as a 5 percent chance of outliving their assets. This risk can be avoided by pooling longevity risk across a large group of participants, such as occurs in DB and VAPP plans.

## VAPP Stabilized VAPP Balances Risks



#### SPONSORS

A VAPP provides stable, predictable contribution requirements. The plan stays funded in all market environments, eliminating PBGC variable rate premiums and creating balance sheet stability.

The only risk the sponsor bears is longevity risk. Because this risk is pooled across all participants, the risk is minimized and not burdensome for the sponsor. Those who live longer in retirement are offset

## Why Stabilized VAPP?

- HR can make predictable contributions.
- Balanced portfolios are used to achieve greater benefits.
- It can withstand market volatility.



by those who do not. This allows the sponsor to fund the plan to the average life expectancy, which reduces the contribution needed to provide a certain level of benefits by eliminating oversaving.

A stabilized VAPP works best when the assets are invested in a balanced portfolio, not a conservative portfolio. High returns are desirable to build reserves, plus a balanced portfolio is expected to provide greater benefits over time.

Thus, stabilized VAPPs allow the sponsor to maximize benefits per dollar of contribution while eliminating the risks that cause contribution volatility.




#### PARTICIPANTS

Participants in a stabilized VAPP get secure, lifelong income, like in a DB plan, but with the added benefit of expected inflation protection in retirement. Because the benefit is expected to increase over a participant's working lifetime as well as in retirement, it is portable. In a typical stabilized VAPP, benefit increases are expected to average 2 percent to 4 percent annually over time.

In any VAPP, the participants ultimately bear the investment risk. In a basic VAPP, that risk is directly reflected in their benefits. In a stabilized VAPP, benefits only decrease if the plan's reserve runs out. Because benefits change frequently and the health of the reserve will be of interest to participants, benefit statements are provided annually to all participants, not just actives. A well-designed, stabilized VAPP has the capacity to withstand market volatility similar to

2008, or even the Great Depression, without benefit declines.

### You Should Consider a Stabilized VAPP

Whether you currently sponsor a DC plan, a traditional DB plan, or a cash balance plan, you should consider a stabilized VAPP. By eliminating and pooling retirement risks wherever possible and balancing the remaining retirement risks in a rational way, stabilized VAPPs combine the best features of traditional DB and DC plans to better meet participants' retirement needs, while providing for both the HR and finance needs of the sponsor. Stabilized VAPPs allow you to make stable, predictable contributions to your participants' lifelong retirement benefits and gets you back to the business of running your business. 

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