

Hybrid Pension Plans

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This article aims to give an overview of the drawbacks of pure defined contribution plans and to analyse the different hybrid plan possibilities, including the various employer and employee risk-sharing options that are available.

Listed companies in Europe are required to account for their employees' retirement benefit obligations under IAS 19* from 2005. Many of these companies are realizing that what they thought was a defined contribution plan, with some guaranteed returns, instead has to be accounted for as a defined benefit plan and therefore record potential deficits in their balance sheets. For example, in Switzerland, the BVG/LPP† mandatory occupational plan legislation provides for a minimum guaranteed return as annually prescribed by the Government (2.5% in 2005). All plans are therefore effectively hybrid plans; defined benefit plans are subject to a minimum defined contribution benefit test and defined contribution plans have a minimum interest guarantee. Similarly, in Belgium, the Vandenbroucke Pension Law of 2004 introduced a minimum guaranteed investment return of 3.25% p.a. on employer contributions to defined contribution pension plans from 1 January 2004 (together with the already mandatory 3.75% return on employee contributions), which is tested over the employee's total service rather than on an annual basis, thus converting all defined contribution plans into hybrid plans. In addition, most pure defined benefit plans are now defining their benefits as a lump sum, thereby reducing employees' certainty of the actual pension they will receive.

Other European countries limit the ability to set up pure defined contribution or pure defined benefit plans. In Spain, defined contribution plans, although without guarantees, are obliged to offer all employees regardless of their age, participation in the same fund to avoid any perceived discrimination, thereby forcing companies to invest in low-risk investments in order to protect the more senior employees.

In the UK, defined contribution plans have been widely introduced; however, many plans are still somewhat hybrid in nature as they normally have a defined benefit legacy and some plans provide guaranteed rates of pension conversion at retirement.

THE PERILS OF PURE DEFINED CONTRIBUTION

So, are defined contribution plans the ideal solution? I will consider these under four headings.

Economics

Although easy to understand and portable, defined contribution plans present the same problems for employees as did defined benefit plans for employers. Taking the UK as an example, the two main contributing factors are as follows:

Interest rates. The decline in interest rates has caused annuity prices to increase significantly. In addition, this decline has resulted in lower investment returns which have, in turn, increased the cost of providing pensions, both before and after retirement.

Improvements in life expectancy. The average life expectancy of a man retiring at 65 has increased from less than 15 years in the 1980s to a projected 20 years for 2020. This improvement has contributed to the increase in the cost of annuities.

Together, these two factors have resulted in annuities providing a pension of about half what it would have been 10 years ago and employees having to significantly increase the percentage of salary they need to put towards their retirement.

Lack of Knowledge

Defined contribution plans were introduced to reduce the volatility of companies' pension costs but, in practice, their introduction included, in most cases, a reduction in the cost for the company as a percentage of payroll. Most companies took this opportunity to increase employees' awareness and appreciation of their benefits and encouraged them to share the cost. From contribution matching all the way to fully flexible benefit plans, employees are expected to take some responsibility for retirement provision. However, unless there is a thorough and continuous education process,

* International Accounting Standard No. 19
† Bundesgesetz über die berufliche Alters-, Hinterbliebenen- und Invalidenvorsorge/Loi sur la prévoyance professionnelle vieillesse, survivants et invalidité

this is often a losing battle. Most people understand that they need to save for retirement: however, few people know how much they need to put in and, even if they do know, there is a problem as to whether they can afford it. Here are a few personal examples:

Example 1. One friend asked me a few years ago how much he should be putting into his pension. He is a very successful estate agent in London and, being passionate about windsurfing, wants to retire to Cornwall as soon as possible. Unfortunately, he was putting (and probably still is) only £50* a month into his pension. When I suggested that he might want to put in more he thought I was talking about £100. I told him how much I was saving myself and he stared at me, probably thinking that I was making some kind of joke. He hasn't mentioned his pension since!

Example 2. Another friend of mine, a mathematician working for one of the Lloyd's syndicates, has twice been offered a stakeholder plan by different employers. She has phoned me each time. I explained to her what an active global equity fund was (and that no, they were not going to invest her money in the shares of an obscure company in an unknown country). I also explained the risk of equities compared with cash and the fact that they can give negative returns. I told her, however, that historically equities had performed better in the long run . . . Unconvinced, she asked me where I was investing *my* money.

Example 3. Consider my sister. With a first-class degree in history, she can tell you in which century that French Romanesque church was built and describe the frescos you will find inside it but she doesn't know much about pensions or investments. Currently living in London to perfect her English and planning to continue her studies here, she was offered a stakeholder plan by the high-street retail employer for which she works part time. She came home with the forms and leaflets and asked me, "Ana, do I have to do this?" I told her it was voluntary but explained to her that she should save for retirement. Her look told me that she has other concerns at the moment and that she will cross that bridge when she comes to it.

Few Europeans understand how much they need to save for retirement; others would only contribute if legally obliged to do so. When it comes to investing, property is probably the only investment most people really understand – not property funds, though, but bricks and mortar. Whether we are mathematicians or history teachers, residential property is something we can see, touch and enjoy and, with some work, sometimes it will even increase in value. Unfortunately, this often stable investment, which generally provides good returns in the long term, is rarely allowed as a tax-effective retirement investment option.

Administration

The cost of running a defined contribution plan is rarely negligible. Some small companies may have difficulties accessing the top investment managers and, if they do, this would be at a cost. Other costs attached to pure defined contribution plans include employee training, helplines, booklets and unit purchase record keeping. In addition, new employees need to be trained and financially educated, with leavers' benefits either transferred or kept on record.

Practicalities

An emerging issue with defined contribution plans is the impact that market performance can, from a financial perspective, have on the ability of older people to retire. A US study conducted in 2002 by Eschtruth & Gemus showed that, for the first time during an economic downturn, participation levels had increased among older employees. The authors attribute this phenomenon to the increasing popularity of 401(k) plans in the USA. Past experience has shown that such employees were normally the first to be retrenched during a recession; however, defined contribution plans may result in companies most wanting employees to retire when they can least afford it.

HYBRID POSSIBILITIES

Between the pure defined benefit and the pure defined contribution plans lies a whole spectrum of employer and employee risk-sharing combinations (see FIGURE 1 overleaf). From career-average plans to cash balance plans, including combinations and sequential hybrid plans, the various types of risk are shared depending on both employee and employer needs. In order to analyse the different hybrid possibilities, it is important to identify the various types of risk involved, as follows:

Investment risk. This is the risk of assets put aside to meet the targeted retirement benefit not performing as expected.

Annuity conversion risk. This is the price of converting a lump sum into an annuity in the open market. It is not guaranteed and varies depending on interest-rate levels, improvements in life expectancy and the person's sex.

Salary risk. This is the uncertainty of whether the plan at retirement will bear any relation to the employee's earnings level and standard of living immediately before retirement.

Mobility risk. This is the potential erosion of the expected retirement benefit when an employee leaves service due to a change of employer, a career break or corporate restructuring.

Other risks include changes to the tax system and to legislation that may affect tax deductions or State benefit levels.

Let's look at some examples of risk-sharing mechanisms.

Combination of Pure DB and Pure DC

Sequential Hybrids

With sequential or 'vertical' hybrids, members are offered either a defined benefit plan or a defined contribution plan dependent on the point in his or her career (see FIGURE 2 overleaf). A so-called 'nursery' scheme would be one that offers a defined contribution plan for employees under the age of, say, 40 and a defined benefit plan for those aged over 40. The advantage of this type of plan is that it provides an easy-to-understand and transferable benefit for those employees who are more mobile and less worried about

* €1 = £0.70; US\$1 = £0.54 as at 7 January 2005



their pension and provides defined benefits for those employees who will appreciate it more. However, the cost of defined benefit plans increases significantly with age. A solution to this problem can be to provide these benefits as part of a 'flex' programme allowing employees to choose which benefits they want to accrue and to what extent.

Combination Hybrids

With combination or 'horizontal' hybrids, both defined benefit and defined contribution benefits are offered simultaneously (see FIGURE 2 below). Examples of these are plans that offer a defined benefit in relation to salary up to a limit and defined contribution for the salary above or those that offer a defined benefit for basic salary and defined contribution for variable pay. The advantage of this type of plan is that it protects employees with a minimum benefit level and also provides for the possibility of employees retiring with a basic pension in a market downturn and then waiting until the economy has improved to buy an annuity with the defined contribution accumulated fund. Some companies in the Netherlands offer this type of hybrid plan to their employees.

Career-Average Plans

Career-average plans are defined benefit plans where the benefit is related to the average salary over a significant period of the employee's career. The pension is normally defined as a percentage of salary each year, with this amount usually being revalued in line with an index, such as for consumer prices or national average earnings. Here, the salary risk mentioned above is shared between employers and employees, the latter usually being given the possibility of making additional voluntary contributions to top up their benefits. This type of plan reduces the mobility risk as employees are not penalized for leaving their company. A recent trend towards this type of plan has developed in the Netherlands, where some large industry-wide pension

funds have changed from final salary plans to indexed career-average plans.

Fixed Dollar Amount Plans

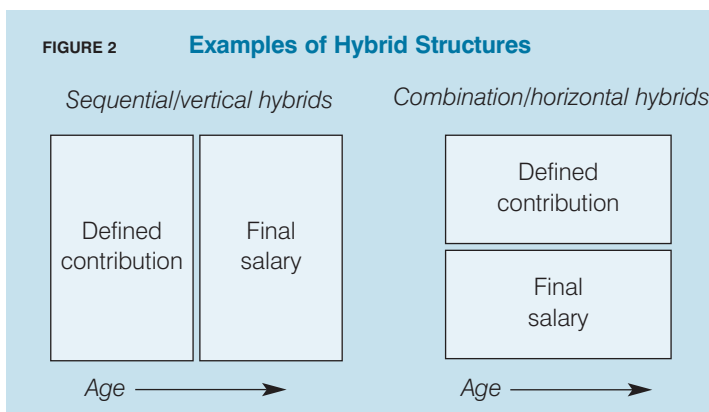
Fixed dollar amount plans, where the benefit is defined as a fixed monetary amount at retirement, are quite common in Germany and the USA for unionized employees, as they are easy to communicate and understand. The employer provides workers with a certain annuity regardless of investment returns or annuity prices; however, it transfers the final salary risk to the employees, who should reassess their retirement benefit levels regularly as these could be seriously eroded by inflation. In order to increase the appreciation of employees and their involvement in their retirement provision, some companies in Germany have introduced 'defined contribution looking plans' where employees can choose how much of a deferred pension they want to buy by deferring current cash compensation.

Retirement Balance Plans

Retirement balance plans provide a benefit that is defined as a lump sum rather than as a pension and it is usually expressed as a percentage of career-average salary times years of service. The benefit can be defined as a percentage of final salary times years of service, in which case they are known as pension equity plans, as in the USA. Pension equity plans are prevalent in Japan and are the main type of defined benefit plan in Australia. At retirement, the company may either share the annuity risk with the employee and make the benefit available as a market-related annuity or expect the employee to buy an annuity in the open market. This type of plan can be provided in combination with a defined contribution plan for variable earnings or earnings above a ceiling, as described above. Some companies in the UK are introducing this type of plan in order to avoid large pensioner obligations. In recent years, some companies have had to spend a significant amount of time and resources addressing their plans' financial status – sometimes as large as their market capitalization – due to their pensioner liability. Most of these companies do not consider their main business to be life assurance or the financing of pensions and they want their pension plans to be a benefit to their employees rather than a burden to themselves.

Underpinning Arrangements

Some defined contribution pension plans include a final salary underpin which provides employees with a minimum benefit. However, this type of plan is not always seen as the answer because, although the company provides employees with some investment risk protection, it has no control over the investment strategy.



Cash Balance Plans

Cash balance plans look similar to pure defined contribution plans and would be situated near the right-hand side of the risk spectrum. This type of pension plan, which is easy to understand and communicate, provides a benefit defined as a percentage of salary, revalued each year by a fixed rate or a rate normally linked to long-term government bonds. The accumulated fund can then either be exchanged for an annuity or be paid as a lump sum. This type of plan is widespread in the USA and some Japanese companies offer it to their employees.

A fixed contribution rate as a percentage of salary could easily be defined to target a final or career average salary benefit, thereby reducing the final salary risk for the employee; however, the guaranteed returns sometimes lead companies to take an excessively conservative approach to investment strategy.

A recent legal case in the USA questioned the fairness of cash balance plans offering the same contribution rate to all employees regardless of their age.* Should the contribution rate favour older people? In my opinion, this would contradict the EU principle that expects two people doing the same job at the same level to be equally compensated for it. In any case, no one should be subject to age discrimination. Most of us will be old one day and when young should have been capable of saving up for retirement.

Another advantage of cash balance plans is their simple administration. Compared with final salary plans, there is no need to keep past-service or past-salary records. Benefits provided as a lump sum avoid the need to keep records of pensions in payment. In contrast to defined contribution plans, there is no need to keep detailed records of past unit purchases for members.

Cash balance plans guarantee a minimum rate of return. Sometimes, however, the minimum becomes a maximum and, if employees are expected to fully appreciate company contributions to their pension plan, they need to be at least as good as cash in hand, especially when cash balance plan contributions are selected by the member as part of a flex plan or as a deferred compensation programme. The guaranteed return may need to be at least equal to the interest on a high-quality bond to avoid employees being forced to choose between a more expensive but more flexible private pension in the market and their employer's 'free of charge' but inflexible pension plan.

It is important to take into account the extent of employees' investment knowledge. A lack of investment control in this type of plan may not be appreciated by employees if, for example, they are equity fund managers in an investment company.

Cash balance plans could be designed so that they provide a guaranteed return for employer contributions while allowing employees investment choice for their

own contributions. Alternatively, they could be designed to provide a guaranteed return for contributions up to a certain limit and an investment choice for contributions over that limit or for additional voluntary contributions. Moreover, this type of plan could be designed to allow employees to participate in any long-term additional returns earned by the plan assets by giving leavers a bonus related to their past service in a similar way to with-profits insurance policies.

So, could cash balance plans be the way to harmonize pension plans in Europe? There are many points in favour of such plans. For example, they fulfil many European countries' minimum return requirements or the requirement to offer the same investment strategy to all members. Contribution rates could be set up to take into account each country's social security levels. As mentioned earlier, they are administratively simple and easy to understand and communicate. Surpluses could be used by the company to reward long-service employees or to finance early retirement benefits.

Lastly, the company liability and cost for this type of plan, despite its being a defined benefit plan, is usually relatively stable as the accounts crediting rate is often set in relation to the valuation discount rate. If the assumed interest rate used to value the liability goes up (which will reduce the present value of the obligation), so will the future credits granted to the employees' accrued nominal fund (which will increase the present value of the obligation by the same amount).

WHAT DOES THE FUTURE HOLD?

In recent years we have seen employees' working patterns change. More and more often employees have gaps in their careers, to return to university, to take a sabbatical, to share parental responsibilities or to take partial retirement. Today, retirement strategy should support both corporate and HR strategies and, if possible, be flexible enough to change as these strategies change. Pension plans can be designed so that they contribute to the company's need to attract and retain employees in a booming market or, by contrast, to contribute to the company's need to downsize and retire employees early or partially in an economic downturn. Hybrid plans offer the possibility of meeting these needs for flexibility. The common theme with such plans is the trade-off between transparency (a plan that is easy to understand and therefore to communicate to employees) and flexibility (at the employer's discretion). In general, the more flexibility that is built in, the more opaque the operation of the plan and the greater the potential for difficulties in employee understanding and appreciation. This means that it is essential for companies to take care with plan design and implementation at each stage. Ω

* For further information, please see 'US Cash Balance Plans Put Up a Fight' (Viewpoint) by Janae Schaeffer, *B&C International*, December 2004.