



Redesigning Defined Benefit Pensions

Realigning the Defined Benefit Pension Contract for a Sustainable Future

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Current Defined Benefit Risk Sharing Contract Problems

- DB Plans are Not Risk-Free for Employees
- Termination Risk is Real
- Inflation Risk is Real
- Extra Contribution Risk is Real
- Confusion Over Surplus (Deficit) Ownership
- Regulatory Risk (Pension Protection Act)

New Realities for Organized Labor and Defined Benefit Plans

- ❖ Plan Solvency Questions Raised by PPA
- ❖ Rising and Unpredictable Costs
- ❖ Investment Volatility Threatens Funding Stability
- ❖ Special Problems of Mature DB Plans
- ❖ New Rules Can Restrict Benefit Improvements and Trigger Benefit Reductions
- ❖ Intergenerational Equity Issues Among Plan Participants Takes on a New Urgency

Macro Trends Undermining Defined Benefit Pensions

- ❖ Decline of Corporate DB Plans
- ❖ Changing International Accounting Rules and Global Movement Toward Financial Transparency
- ❖ Scrutiny of Credit Rating Agencies (2006 Moody's Report on Multiemployer Plans)
- ❖ Non-Union Competition

Pension Decisions Facing the Organized Labor in The Next Decade:

1. Can We Sustain Our Traditional Defined Benefit Plans?
2. Should We Convert to Defined Contribution Plans?
3. **Should We Adopt a Hybrid Plan Design Based on a New Set of Risk Sharing Rules?**
4. How Do We Resolve the “Legacy” Cost Problem in Our Existing Defined Benefit Plans?

Why We Rejected the Cash Balance Plan Design?

- ❖ No Upside Investment Opportunity for Participants
- ❖ Annual Floor Accrual Decreases with Age
- ❖ Forfeitures for Turnover Only Go to Reduce Employer Cost
- ❖ Usual Payment Form is Lump-Sum and If Annuity is Elected, Prices are Pre-Determined Conservatively

Is There a Third Way: Hybrid Plan – “Variable Defined Benefit”

- ❖ Fairly Priced Benefits with Stable Contributions
- ❖ Realigned Risk Sharing Among Stakeholders
- ❖ High Probability of Delivering Pension Promise
- ❖ High Probability of Remaining Fully Funded
- ❖ Meets Regulatory and PPA Tests
- ❖ Based on Effective and Disciplined Governance Model
- ❖ Retains Best Features of Defined Benefit Design

Designing the Variable Defined Benefit Plan

- ❖ Like DB, Pools for Mortality and Retirement Age Risk
- ❖ Like DB, Turnover Gains Used to Increase Benefits to Longer Term Participants via Forfeitures
- ❖ Like DB, No Individual Account Balances
- ❖ Like DB, Investments are Pooled and Professionally Managed

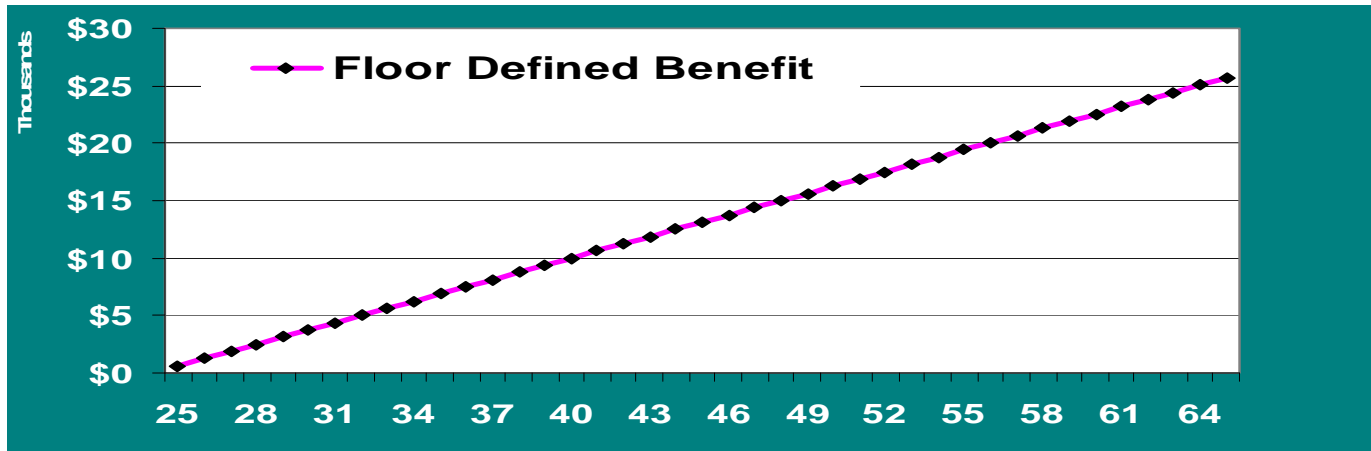
Designing the Variable Defined Benefit Plan (Con't)

- Employee and Employer Share a Level of Investment Risk
- A Lower-Risk Interest Rate Assumption (e.g. 5.5%) is Adopted Which Acts to Reduce Investment Risk
- A “Floor” Annual Benefit Accrual is Set Based on Bargained Contributions, Participant Demographics, and the Lower-Risk Interest Rate Assumption

Benefits are Adjusted Annually Retrospectively Based on:

- Positive Investment Performance Relative to the Lower Interest Rate Increases Benefits, But Only After Meeting a Reserve Threshold (e.g. 1% Over Interest Rate Assumption)
- Negative Investment Performance Relative to the Lower Interest Rate Reduces the Benefit, But Not Below the Annual Floor Accrual
- Investment Risk is Further Mitigated by Immunizing Retiree Benefit Liability at Retirement

Variable DB Plan: Determine the Floor Benefit Accrual



- ❖ Negotiate a Contribution Level (assume it's \$1/hour)
- ❖ Actuary Calculates Floor Accrual Based on:
 - Demographics of the Plan's Active Membership
 - Assumed Hours Worked Per Year – (e.g. 1,750)
 - A Guaranteed Investment Rate – 5.5%
 - Actuarially Determined Floor Benefit is \$50/mo/yos
 - **After 20 Years of Service, the Projected Pension at 65 is \$12,000; with 30 years, \$18,000; 40 years, \$24,000**

Variable DB Plan Mechanics

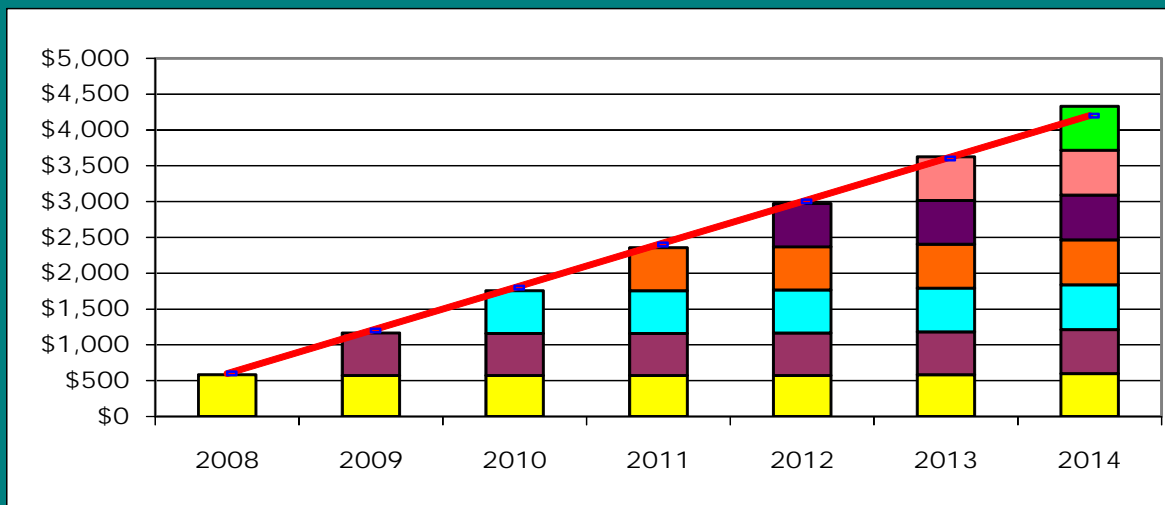
- Measured in Unit Values that are a Function of Investment Return Each Year
- Units Accumulate Each Year
- Benefit Accrual is Function of Accumulated Units and Changing Unit Value
- Each Years Accrued Pension is a Weighted Average of Prior Year Accruals that Changes with Each Year's Investment Return
- Timing of Returns is Important – Positive Returns at End of Career Will Increase Final Benefit (Negative Returns Will Reduce Final Benefit)

Variable DB Plan Benefit Example

Guaranteed Return **5.5%**
Reserve % **1.00%**

Year	BOY Floor Accrual	BOY Unit Value	BOY Unit #	BOY Cmltv Unit	DY Actual Return	EOY Excess Return	EOY Accrual 2007	EOY Accrual 2008	EOY Accrual 2009	EOY Accrual 2010	EOY Accrual 2011	EOY Accrual 2012	EOY Accrual 2013
2007	\$600	\$10.00	60.0	60.0	3.0%	-2.5%	\$585	\$576	\$573	\$573	\$576	\$585	\$599
2008	\$600	\$9.75	61.5	121.5	4.0%	-1.5%		\$591	\$588	\$588	\$591	\$600	\$615
2009	\$600	\$9.60	62.5	184.0	5.0%	-0.5%		\$597	\$597	\$600	\$603	\$609	\$624
2010	\$600	\$9.56	62.8	246.8	6.0%	0.0%			\$600	\$603	\$612	\$627	
2011	\$600	\$9.56	62.8	309.6	7.0%	0.5%				\$603	\$612	\$627	
2012	\$600	\$9.60	62.5	372.1	8.0%	1.5%					\$609	\$624	
2013	\$600	\$9.75	61.6	433.6	9.0%	2.5%						\$615	
2014		\$9.99											

Accrued Pension	2007	2008	2009	2010	2011	2012	2013
Accrual for Year	\$585	\$582	\$591	\$600	\$615	\$654	\$706



From Shares	\$4,332
Floor benefit	\$4,200
Benefit	\$4,332

Design an Investment Strategy that Supports the Objectives of the Variable DB Plan

- Maintain Secure Annual Floor Benefit Accrual at Stable Cost
- Deliver Modest Investment Return Premium that Supports Regular Benefit Improvements
- Provide Steady and Predictable Investment Returns (Control Volatility) Measured by Standard Deviation of Returns
- Control Short-Fall Funding Risk Measured by Funded Ratio

Investment Strategy for the Variable DB Plan

- Significantly Reduce Equity Exposure
- Significantly Reduce Standard Deviation of Returns Over Liabilities (5-6% Range)
- Reduce the Risk of Shortfall Funding (96% Funded at the 5th Percentile, with a Mean Funded Ratio of 106% Based on Stochastic Projections)
- Generates a 85% Probability of Producing a Annual Pension Greater than the Floor Guaranteed Benefit

Variable DB Plan: Aligning the Interests of Stakeholders

Labor Interests

- ❖ High Probability of Benefit Security and Regular Benefit Improvements
- ❖ Participants Own Fund Surpluses (Deficits)
- ❖ Provides Similar Security as DB With Respect to Retirement and Post-Retirement Mortality
- ❖ Can Provide Death, Disability and Early Retirement Benefits
- ❖ Offers the Potential for Inflation Protection in Retirement

Management Interests

- ❖ Substantially Reduces the Risk of Unfunded Liabilities
- ❖ Defines and Adjusts the Real Cost of Benefits
- ❖ Stabilizes Employer Contribution Budget
- ❖ Answers Concerns of Corporate Accounting and Credit Agencies
- ❖ Fixes the Problem of Generating Large Fund Surpluses, and the Employer Dilemma of Overpaying for Benefits

Mutual Interests

- ❖ Immunization Substantially Reduces the Risk of Investment Volatility for Assets Covering Post Retirement Liabilities
- ❖ Investment Risk Sharing Rules Are Institutionalized
- ❖ More Workable Governance Model