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From the Editor

Make Pensions More Like 401(k)s

Policymakers are studying how to engineer 401(k)s and other defined contribution ("DC") plans to function more like pensions. The goal is assisting retirees in managing their mortality, investment and inflation risks. A traditional pension (aka "defined benefit plan" or "DB") automatically manages these risks without any worker involvement. And, benefit dollar-for-dollar, pensions are more economical (less expensive) than DCs because pensions enable individuals to share these challenges and offload most decisions to professional managers. In a DC it is every person for him or herself.

I suggest the solution may be to build a better pension plan rather than make DC's more pension-like. Employers choose DCs over pensions simply because pensions are much riskier to the bottom line. By reducing the employer pension risk to the level of DCs while maintaining the strengths of pensions in helping workers and retirees, it is possible to create a pension program that works for both employees and employers.

A company's pension risk only ends when the plan terminates and everybody is paid. Until then, poor investment returns, decreases in interest rates (liabilities grow as rates decline), unexpected employee longevity or other unpredictable events, can trigger additional liabilities – hurting both cash flow and profits. And, there is little upside because overfunding from favorable investments or higher contribution levels can be recaptured only by paying a hefty excise taxes and other penalties. The bottom line for a corporate decisionmaker is that she only can lose from having a pension plan. DCs, on the other hand, are safer because its costs (contributions and administration) are predictable. Even with periodic administrative errors and the spate of class action lawsuits, once the contribution is made, there is relatively little risk of unexpected charges.

With company risk the problem, the obvious solution is to remove that risk. I'll focus on two likely possibilities. The first is elegantly simple: design a plan in which at the end of each year the employer's contributions, together with any elective employee contributions, are used to buy a single premium deferred annuity on behalf of each participant. The annuity payments could begin at the later of a stated age (say, 65) or retirement or disability. There should be a death benefit payable to a surviving spouse/partner or minor kids but, to maximize retirement benefits and minimize fees, there should not be any other pre-retirement death benefit (except to return the deceased employee's own contributions), loans or hardship withdrawals. The annuity should be portable as employees job hop. For an added fee, the annuity contract also could have an inflation adjustment. A participant's pension would be the sum of the annual annuities purchased over his career. This annuity-only pension would provide lifetime income with absolutely no funding, investment or similar risks to employers.

Two changes would be needed for this to be workable.

First, the Department of Labor ("DOL") should issue guidance protecting plan fiduciaries from the non-diversified investment in the annuity contracts as long as the insurer met basic financial strength standards at the time of each purchase.

Second, insurance companies would need to offer these contracts at group rates. This involves a classic chicken/egg problem. To be profitable to insurers over time, a significant number of employers and participants would need to sign-on. To get employers to adopt, there would need to be a choice of reasonably priced insurance products. I believe that, with a slight nudge from regulators, if an insurer builds the product, employers will come.

The second possibility is a takeoff from the original "secure choice pension" developed by Hank Kim at the National Conference on Public Employee Retirement Systems ("NCPERS") some 15 years ago for private sector workers. Basically, the expected pension benefit formula would use a career average salary (e.g., an age 65 pension of one percent of each year's salary) to be funded using conservative actuarial assumptions. Employers and (possibly) employees would make annual contributions. Funding waivers in bad times and contribution holidays in good would be forbidden. No contribution would mean zero accrual for the year. Plan funds would be professionally invested in a long term diversified portfolio. If all goes as predicted, employees would receive the expected pension. However, if things went well (e.g., better than expect investment performance), then benefits would be higher. Poor experience, such as weak long term investment returns or unexpected longevity, could trigger reduced benefits. By using conservative assumptions and a reserve account (to squirrel-away money in good years), the likelihood and degree of any benefit adjustments should be small. Crucially, employers would have no liability for underfunding if they made the required contributions. As with the annuity proposal, benefits would be paid only as a pension – no loans, hardship withdrawals or lump sum options.

For this adjustable pension to work, ERISA's vesting and benefit accrual rules would need modification to permit increases/decreases in benefits based on actual experience. The Internal Revenue Service or DOL would need to set the reasonable actuarial factors (to prevent abuse) and provide safe harbor protection if sound investment and actuarial practices are followed.

Both the annuity-only or adjustable pension would work even better if employers could join forces using a multiple employer approach – large numbers of participants would reduce costs and further spread actuarial and investment risks.

For workers, pensions are superior. With some DC-type adjustments they also will be good for employers.

(Readers interested in proposals to make DC's more pension-like and other retirement solutions should read *Wealth After Work,* edited by Gale, Iwry & John (Brookings 2021). The book offers a superb analysis of managed payouts, investment collars, longevity insurance, SeLFIES (my favorite), tontines and other ideas to help folks turn their savings into lifetime retirement income.)

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

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