The Future of Retirement Benefits in the U.S. Employer Policy, Benefits and an Older Population

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Introduction

Employer-sponsored benefit plans are a key component of financial security for many U.S. individuals. Benefit plans were first offered on a widespread basis in organizations with unionized environments, but they rapidly spread to salaried workforces as well. Traditional employee benefit plans in larger employers have been designed with several goals in mind:

- Protect employees and their dependents in the event of medical expenses, and for loss of income from death, disability and retirement.
- Strengthen the ties between company and employee.
- Offer a competitive employment environment.
- For many, retirement benefits have been structured to reward and encourage career employment, while at the same time, making it relatively easy for employees who were in their 60s and had spent a career with the company to retire.

Plans were designed to allocate benefit dollars more heavily to those with families and to those who were older, but for many years, this was largely hidden from employees, and not explicitly recognized or discussed by most plan sponsors. The structure of tax laws was also an important driver of benefit plan structure.

Then in the 1970s, with the growth of health care costs and emergence of global competition, there was more focus on what was being spent for benefits and for whom. In the 1980s, with the growth of flexible benefit plans, there was increasing focus on what was spent and how it was allocated to different employee groups. Flexible benefit plans offered a way to let employees take what was being spent for benefits and allow employees to make different choices.

In designing plans, it became clear that there were subsidies inherent in traditional plans. It became much more difficult to hide them, and many employers sought to reduce them as they changed their benefit structures. At the same time, there was recognition that the workforce was not homogenous, and that employees varied by family type.

Demographic and Societal Background

In 1995, the Baby Boom is well advanced into their adult lives, and issues related to retirement security are increasingly on the minds of employees, their employers and public policy makers. Many higher and middle-income individuals in their 40s and 50s are no longer assuming their retirement security, and are concerned about benefits and what they will provide. Over the last 15 years, income has been flat or declined for many people. Job security has become a major focus and concern for many Americans. Middle-class Americans who might have taken financial security almost for granted are becoming more concerned that, in fact, they can assume less about it. Employers and employees are focusing on changes in the social contract, the deal between employer and employees.

Financial security is the product of a variety of different activities and programs affecting each individual. They include:

- Personal skills, educational credentials, and the things done to maintain skills and keep them up-to-date.

- Job security and the ability to move from assignment to assignment either within the existing company or outside of it.

- Government programs, including Social Security, Medicare and social safety net programs.

- Employee benefits provided by employers, including retirement and active employee benefits.

- Provisions for support when help is needed with the activities of daily living, including personal help from family members, long-term care insurance, benefit and government programs.

- Personal savings and assets.

Meeting financial security needs is creating challenges and resource strains for employers and governmental units alike. Both must respond to the same demographic challenges, and these challenges lead to a strong need for more resources for financial security. Some of the questions that employers and benefit plan sponsors are asking include:

- How is the population (and the workforce) changing?
- How will the changing age mix affect retirement benefits, needs and resources?
- What factors are important to consider in retirement planning?
- What are the implications of all of the changes?

As plan managers look at their benefits, there are some questions that apply to the total program:

- What is the appropriate division of responsibility between employers and employees?
- What is the optimum amount of choice? How much are we willing to pay for choice?
- How do we support the needs of a diverse workforce with more limited resources?
- How should risk be shared with employees?

Additional questions for retirement benefit programs:

- Should we offer defined benefit or defined contribution plans, or what combination?
- How much commitment does the company have for retiree health benefits?
- What is the role of the company in educating employees and helping them do their own retirement planning?

Governments are faced with issues, both in providing programs for the public at large and for their employees. When we speak of government here, we are focusing on the issues relating to the public, and not to the employee programs for their own employees. The public program issues can be seen in two dimensions:

1. There is a struggle for the same resources -- states and the federal government can be seen as part of a tug-of-war.

2. Different groups are also competing for those resources. The elderly and the young both have needs, and to some extent, there is a tradeoff between meeting those needs. Health care has consumed large amounts of resources, and there is a tradeoff between health care and other needs.

Public Policy and Employer-Sponsored Retirement Benefits

There are many requirements imposed on retirement benefits in the United States. Public policy is somewhat ambivalent toward employer-sponsored retirement benefits. Tax preferences are available through plans (tax qualified plans) to provide retirement benefits to employees as follows:

- The amounts contributed to tax-qualified plans are not taxed as current income to employees; these amounts are subject to income tax when paid out as benefits.

- The investment income held in tax-qualified plans is tax deferred; these amounts are subject to income tax when paid out as benefits.

In exchange for these tax benefits, there are numerous requirements which apply to these plans. The last decade has seen a growing number of requirements which are applied to these plans, so that stricter rules apply and benefits are limited particularly for the higher paid. A key principal is that benefits may not favor the highly paid.

The regulatory requirements have become considerably more difficult in the last 15 years, and smaller employers have discontinued many of their retirement plans. There has been frequent change in the requirements with a constant stream of new legislative and regulatory requirements. In addition to many new statutory requirements, the enforcement environment has become far more stringent so that practices which were commonplace ten years ago are clearly unacceptable and risky today. Plan sponsors view the public policy environment as adverse to benefits. This is particularly troublesome since the need for retirement benefits will increase as the population ages.

Public policy points to a retirement age range of 60-65. Social Security benefits are available as early as 62. The age for receipt of full benefits is gradually being increased to age 67 for people born in 1960. ERISA, a major pension law, does not permit a normal retirement age (or full benefit retirement age) later than age 65. One of the key questions of the next few years is whether public policy will be modified to provide for a later retirement age.

There is no unified national retirement policy within the U.S. In 1994, the National Congressional Election results moved the Congress to be much more heavily Republican. Many members of Congress would like to see major changes in tax policy. The tax system is likely to be revisited in 1996, and it is likely that there will be major proposals for change. There is no announced position for either the development of a very different benefit policy or a unified national retirement policy. However, employee benefits are major tax preference items. Pension and health and welfare benefits are two of the three major areas of "tax expenditures" and if the tax system is overhauled, it would not be surprising to see major changes in benefit taxation. Other countries, such as Australia and New Zealand, have changed their tax structures for retirement benefits.

Employee Benefits and Public Policy Toward Older Workers

Under traditional benefit designs, costs increased with age, but these costs were generally hidden from the employees and often from the plan sponsor as well, since costs were reviewed based on averages for the whole group, rather than as amounts by employee.

There have been, however, a number of public policy initiatives focusing on age and employee benefit management. Age discrimination has been a workplace issue for many years, but benefits were not generally the focus of this discussion. After 1978, when the age discrimination legislation was amended, there were guidelines promulgated to what benefit designs would be required in order to avoid age discrimination. At that point, benefit accruals in defined benefit retirement plans could be discontinued after normal retirement age. Subsequent legislation required employers to continue retirement benefit accrual beyond normal retirement age.

The focus of the regulations after the 1978 amendments to the Age Discrimination in Employment Act was cost equalization. Employers were allowed to reduce benefits with increases in age so long as the costs by age did not discriminate. This was defined as requiring spending which did not decrease with increasing age. The purpose of this was to balance cost and benefit maintenance so that benefits did not become a disincentive to the hiring of older workers.

Traditional retirement benefits encouraged employees to stay until retirement. Many employers offered retiree health benefits which were available only to those who retired from the company. The defined benefit plan benefits also were heavily earned in the years before retirement, particularly where pay was continuing to increase and where benefits were based on final average earnings.

As employers downsized, they often determined that it would be beneficial to have those employees eligible for early retirement leave. So many employers offered generous early retirement window programs, temporary programs which included additional retirement benefits to those who retired during the window period. The result of the window programs was that many workers retired early during these periods.

There has been frequent litigation regarding age discrimination. Early retirement windows have been one of the subjects of this litigation. Today, when structuring windows, age discrimination is one of the concerns which must be addressed. These lawsuits are frequently brought by management personnel who have been dismissed.

Public Policy and Retiree Health

For Americans who are over age 65, the first layer of health benefit protection is being provided by Medicare. Medicare offers hospital and physician benefits subject to deductibles and co-payments. The Republican Congress has proposed significant cuts in Medicare spending, and as of mid-October, 1995, this issue is being hotly debated in Congress. Cuts in Medicare spending may well result in cost shifting to employers sponsoring retiree plans, as well as reductions in payments to health care providers and increased cost sharing by beneficiaries.

Medicare legislation is also likely to lead to more managed care plans for Medicare beneficiaries. Under these plans, the federal government provides a payment to the plan which offers a more comprehensive benefit package to the individual electing the plan. The plan assumes the risk.

Retiree health is subject to fewer rules than pensions and the constraints on these programs have been defined as much in the courts as in Congress. These plans are, of course, subject to contract law, and much of the litigation is based on contract law.

Unlike pensions, there is no requirement that these plans be prefunded, and opportunities to prefund them on a tax-preferred basis are quite limited. There are also no vesting requirements and benefits are at risk for many employees.

As with pensions, change over the last decade has been adverse to the interests of plan sponsors and has discouraged them from offering the benefits. Medicare legislation may further discourage employers from offering benefits.

The Business Environment and the Social Contract

Global competition, technology, changing values and demographics are all encouraging employers to redefine the relationship between employer and employee. The traditional relationship was built around the paradigm that reasonable performers were secure in their jobs, and it was the individual who could decide whether or not to accept the company's offer of a lifetime job and security. The new paradigm is based on a job so long as the business supports it, and security has become the responsibility of the individual. Companies are bought and sold, and long-term job security no longer exists.

Traditional retirement plans were designed to provide good benefits to career employees -- with the notion that it was the employees who chose whether to stay long or leave early. These plans provided much lower benefits to those who left early, particularly before early retirement age. Today, when jobs often disappear, a retirement benefit structure is needed which will provide a fair benefit regardless of tenure at termination from each job.

The New Social Contract

There has been a great deal of focus lately on a "new social contract" or "changing employment relationship." Under the traditional approach, there was an assumption of job security, and it was assumed that lifetime employment was an option available to the employee, except in the event of very poor performance, or some discontinuity in the business. However, discontinuity in the business was seen as an exception, rather than a norm.

The last decade has seen a tremendous number of companies go through changes in ownership, re-engineering and restructuring. Most of the companies which would have been viewed as the bastions of employment stability including large well-established banks, telecommunications companies, large steel and auto companies, utilities, etc. have had substantial dislocation of their workforces.

This has led to a focus on a new social contract. Exhibit I contrasts some of the characteristics of the new and old social contracts.

EXHIBIT 1

Traditional	New Approach
A growing workforce	Downsizing and rightsizing
Stability	Change and uncertainty
Permanent employees	A mix of permanent and contingent employees; i.e., a flexible workforce
Paternalism and entitlement	Employee responsibility
Retirement as one-time event	Gradual retirement
Employee retention	Targeted turnover
Job security	Education/skill building to remain employable (here or elsewhere)
Learning at workforce entry	Life-long learning

We can think about the contract as implying different things with respect to how employment terminates and to the period when employment continues.

The evolving contract and rationale for termination of employment: Under the old way of thinking, termination could be at the employer's request for cause, or for poor performance, but termination for poor performance was uncommon. In addition, it was relatively rare to look carefully at the fit of the individual and the job. The individual was free and often chose to leave for a better opportunity, but the option of long-term employment was there. Depending on the organization and industry, many employees chose very long-term employment.

Under the new paradigm, things are reorganized frequently, and jobs tend to be reorganized out if they do not fit the needs of the organization going forward. The reasons for termination have expanded to include reorganization and downsizing, as well as cause and performance. Organizations are also much more likely to take action on poor performance. The decision to remain with an organization or leave is no longer the employee's choice. It is much more often the company's choice.

Retirement benefit plans were designed for high benefits for those who stayed to normal retirement age and for low benefits for those who left very early or in their mid-years, but that was not a problem since those who left early did so based on their own choice. Today, this pattern is seen as more of a problem.

The evolving contract and periods of continued employment: Under the old way of thinking, planning and expecting change were not part of the social fabric. Under the new way of thinking, change is to be expected and is part of the environment.

Under the old way of thinking, while there was ongoing training, its importance had not been recognized both to the individual and the company. Under the new way of thinking, maintaining human capital is a major issue to both. Under the old way of thinking, there was a lot of structure and hierarchy. Under the new way of thinking, there is a much flatter organization and less hierarchy.

The evolution in the contract means that pay systems need to be more flexible. Many pay systems are moving to include a higher component of incentive compensation.

The transition to different cultures is difficult, both for employees and for employers. For the employee over age 45 with long service, this is particularly difficult since many of these employees built their lives based on expectations which grew out of the old culture and a different social contract. One human resources officer in looking at the accrual pattern under a traditional defined benefit plan expressed the needs of the new environment with two statements:

1. "We need to offer a plan such that if an employee leaves at any point in time we are square and treat the employee fairly."

2. "We need to protect our employees in the event we are acquired. In our industry, 25 percent to 33 percent of the employees will usually lose their jobs after an acquisition."

That human resources officer was very uncomfortable with the traditional defined benefit plan with its steep accrual pattern.

Traditional Retirement Plan Choices: Do They Work Today?

Traditional retirement plan designs included defined benefit and defined contribution plans. The traditional defined benefit plan used a final average earnings formula, so that benefits would be a percentage multiplied by years of service and average earnings in the final five years of employment. In contrast, defined contribution plans offered an individual account based on amounts credited to an employee account with interest.

The relevance of traditional plans is not a new subject. The death of defined benefit plans has been declared periodically over the last 50 years because:

- They are old fashioned and too complex.

- Younger employees don't appreciate them.

- They are too risky.

Nevertheless, larger employers (those with over 1,000 employees) have continued these plans. There has been little change in their frequency of use, even though the number of employees covered has declined as employment patterns shifted. The principal reasons for this are:

- They are efficient. They have delivered the most dollars for those who stay to retirement for every dollar the employer invested. (That was the goal of many employers in their retirement plans.)

- The risk inherent in defined benefit plans carried reward with it, and the employers who have managed their assets well have been well rewarded for taking that risk.

Plan Choices of the 1990s

For those employers who feel that the old options don't work well today, new options supplement traditional defined benefit and defined contribution plans. Hybrid plans offer features of both traditional defined benefit and defined contribution plans. Two examples of hybrid plans are as follows:

1. **Cash balance plan**. A defined benefit plan where the benefit is defined as an account within the plan. The plan specifies the rates of contribution and investment return (independent of plan asset performance) to be credited to the participant's account. This plan looks like a defined contribution plan for benefit accrual purposes.

2. **Target benefit plan**. A defined contribution plan where the benefit is calculated to reproduce the benefits in a defined benefit formula by individual. The benefit accrual pattern in this type of plan is more like a defined benefit plan.

This paper focuses on evolving policy and uses cash balance as an example of the new solution. Exhibit 2 compares the characteristics of cash balance, traditional final average pay defined benefit plans, and traditional defined contribution plans.

EXHIBIT 2

	Traditional Defined Benefit	Cash Balance	Traditional Defined Contribution
Allocation of dollars	Heavily to later years of service	Heavier to early years of service (can modify with formula)	Heavily to early years of service
Investment risk is borne by	Employer	Employer	Employee
Ability to grandfather prior defined benefit formula inside plan	Yes	Yes	No
Ability to offer early retirement windows inside plan	Yes	Yes	No
Investment choices available to employees	No	No	Yes
Ability to vary accruals by age/length of service	Formula does automatically but not obvious	Yes..subject to passing nondiscrimination tests	Yes..subject to passing nondiscrimination tests
Can base benefits on profits	No	No	Yes
Inflation risk	Usually employer	Employer	Employee

Hybrid plan designs offer some of the features of both defined benefit plans and defined contribution plans so that the employer can offer a cash balance defined benefit plan which offers the following characteristics:

- Benefits accrue like a traditional defined contribution plan (or in a pattern selected by the employer).
- Lump sums are the usual form of benefit payout.
- Benefits are communicated as an "account balance."

These hybrid plans are like defined benefit plans with regard to the following:

- Assets are pooled in a single fund; there are no individual investment accounts. This reduces recordkeeping requirements.
- The employer retains the investment risk on plan funds. Depending on objectives, this can be seen as an advantage or disadvantage, but overall, funds where employers have made the investment decisions generally have done better.
- There is PBGC insurance on the benefits. Again, depending on the point of view, this might be viewed as an advantage or a disadvantage. Most employers would view this as a disadvantage.
- In the calculation of costs, the employer can recognize expected terminations of employment, etc. Initial costs are lower than under defined contribution because non-vested terminations are recognized through actuarial assumptions rather than after they occur.
- Increases in benefits for past periods can be granted, and early retirement window benefits can be offered inside the plan.

The Social Contract and Plan Design Choice

As the social contract changes, the issues in plan design choice focus on what happens if people leave at different times during their careers, and on growing employee responsibility. The key differences in the traditional plan designs include the following:

- **Benefit accrual.** Traditional defined benefit (final average earnings) plans which provide for heavy benefit accruals late in the employee's career are seen as fitting the old social contract, whereas defined contribution plans on cash balance designs provide for much heavier benefit accruals earlier and, therefore, they fit better with different employer contracts.

- **Method of payout.** Traditional defined benefit plans usually offer payout as monthly income fitting the entitlement orientation of the old social contract, whereas cash balance and defined contribution plans usually offer payout as lump sums which fits better to the new contract. All plan types can offer other forms of payout as options.

Case Studies

Not-For-Profit Organization. An organization which sponsored a traditional final average earnings defined benefit plan analyzed its culture, work patterns, and workforce and found that:

- Few employees stayed for as long as ten years.

- There were different job groups with different characteristics at hire including:
  - younger professionals who joined the firm in order to get initial experience which would help them in building a career.
  - senior professionals who came as an "end of career" or "second career" job which depended on their credibility and experience.
  - clerical and administrative staff who were essentially like these groups at any organization.

- The existing plan was not valued or appreciated.

- Employees were not being encouraged to save, although, there was a savings program, but without a match.

Focus groups were conducted with both rank and file employees and managers. The manager group was used to test and provide input into alternative plan design concepts.

The organization implemented a cash balance plan and added a match to the savings program. They worked to encourage employee savings. Longer-term employees at the time of change were given the greater of the benefit under the old plan and the cash balance plan. Benefit statements were produced which combined balances under the matched savings program and the cash balance plan, and focused employees on the total retirement program. This program has been in operation for close to ten years, and the organization is very pleased with the results.

Health Care System. A multi-location integrated health care organization sponsored a traditional final average earnings defined benefit plan at its hospitals and some of its other locations, and an organization-sponsored defined contribution plan at other locations. This organization was making acquisition to respond to the changing market, and had new services such as home health, physician offices, and nursing homes to its traditional hospital business. In looking at the situation, they found that:

- The diverse approach to benefits was a barrier to transfers and to meeting federal requirements.

- With the new businesses, the requirements for professionals were increasingly diverse.

- Their culture which had supported paternalism in the past was changing and needed to move away from paternalism.

- The existing plan was not valued or appreciated, particularly by younger employees.

- Employees were not being encouraged to save, although, there was a savings program, but without a match.

A task force of human resource and financial managers representing diverse business units studied retirement strategy and developed policy for retirement benefits. Focus groups were conducted with rank and file employees.

The organization decided to move all employees into a new cash balance approach. This permitted effective integration of groups from both prior plans. Existing employees who participated in the defined benefit plan were given the better of the two plans -- their old plan and the new plan with the calculation done at termination.

The existing defined benefit plan had a surplus which was used to help fund the benefits under the amended plan.

Financial Planning for Retirement

Many Americans do not have the skills or interest in saving and financial planning to develop and execute a regular program of savings. For them, the new environment is one of major challenge. There are several different issues:

It is important to start saving early, as money saved early grows much more than money saved later.

It is important to save enough, and many individuals feel that they are unable to do that. This may be the result of real need for funds for food and daily living, or the result of expectations about lifestyle.

Those who save may not understand investments at all and may, therefore, do poorly, either through sticking to fixed dollar, or through moving funds at the wrong time.

With personal computers, new options for supporting employee financial planning are available at modest cost. Employers can be expected to encourage employees to do financial and retirement planning and some will sponsor educational programs in that regard.

Other Approaches to Meet the Changing Employment Environment

Defined contribution plans have been very popular in the U.S. Larger employers have commonly adopted them as supplemental plans, but medium and smaller companies have been more likely to choose them as primary retirement vehicles. Many of these plans require employee contributions.

The cash balance approach discussed here assumes that the focus of employer-financed benefits will be plan sponsored and managed by the employer. The cash balance approach will be an excellent alternative for employers favoring such an approach. Other possible methods include plans like TIAA-CREF, or a multi-employer plan as an alternative.

TIAA-CREF is a special company offering a defined contribution program offered to college and university faculty. Individual annuity contracts are provided to each covered person and the employer contributions are deposited in these contracts, which are fully owned by the individuals. This model has been very effective for the academic community in providing retirement benefits, but there are several reasons why it probably does not offer a model which would be acceptable for business in general. Some of the key points are as follows:

- The individuals accepting teaching positions often stay within such positions for life, although they change institutions. There is not that much movement in or out of this profession.

- TIAA-CREF has a preferred economic situation when compared to commercial insurance companies, in that it is authorized by special legislation which makes it tax exempt and gives it preferred status.

- TIAA-CREF has very strong acceptance and status within the academic community, and it is unlikely that an insurance company would have such status with business.

- The program identity is with TIAA-CREF and not the employer, but this is widely-accepted within the profession. Private businesses generally want more identity for their benefits and more credit for them.

- Contributions are often considerably higher than most private businesses are willing to spend for benefits. (This is part of the reason why accumulations tend to be considerable at the point of retirement.) At the level of contributions commonly made to defined benefit plans, results would be much less satisfactory.

There may be other situations which such a model would work well even though the authors feel it would not work well for business generally.

Another type of model is the multi-employer defined benefit plan. Such plans have been common for U.S. negotiated groups, and are the only way to provide effective retirement benefits for certain groups who are tied to a union, but work for many employers. Examples are longshoremen, construction workers, milk truck drivers, etc.

These plans are very appealing in theory, but have not worked in practice in many cases. Corporations who can participate in these plans for selected groups of workers are reluctant to do so. Some of the problems with these plans are as follows:

- When an industry declines, the plan can be left with many retirees and not enough money. The surviving companies can be left with liabilities related to those who left. This has been partly solved by requiring employers who leave the plan to pay a withdrawal liability.

- Each employer has limited control over the plan, and ultimately things which impact their costs. Companies thought they had a fixed cost in cents per hour, but later found that their cost was much greater. U.S. law imposes withdrawal liability on those who leave.

- These plans address the needs of the changing work environment only so long as people move within covered employment. Otherwise, they do not work either.

These issues are addressed from the perspective of retirement benefits tied directly to employment.

The Future

Change is the biggest characteristic of the 1990s, and it seems inevitable that there will be more change. The evolving social contract is but one evidence of this change. Change is reflected in organizational structure, culture, compensation and benefits. The playout of these issues will be a substantial impact on policy toward older workers. As a result of the ongoing change, many employers are re-examining their retirement strategies. The questions they are asking include: "Why do we offer this program?" "Do we get value from it?" "Is it a good way to spend our money?" The environment and the emphasis have shifted. Employers are concerned about employee appreciation, and about implementing the evolving social contract.

We predict the following changes in the retirement package:

1. Increase in employee responsibility for retirement. Financial planning at the personal level will be much more widespread. Personal security will depend heavily on what the individual has done about planning.

2. Reduction in employer coverage for medical, for Medicare eligible for retirees, and increase in employee contributions for retiree health at any age.

3. Increased focus on Medicare risk contracts as a way to cover retiree health.

4. Decline in employer support for benefits provided to all, and a shift in emphasis to matched savings programs which focus on employee responsibility.

5. Redesign of many pension plans to a cash balance approach, or other approach which modifies the benefit accrual pattern while retaining the employer investment risk and favorable returns that can accrue from risk assumption.

6. Increased choice in investment options within employee savings and more savings education.

7. Continued focus on early retirement windows in special situations, and reductions in subsidies in non-window situations.

8. More options for gradual retirement.

9. Gradual increase in full retirement ages.

10. Continued use of corporate restructuring and accompanying elimination of jobs.

11. Increased focus on second and third careers.

Conclusion

As the workforce and social contract are changing, total retirement program design, as well as pension plan design, will need to be revisited. Employees will have more responsibility, and a new type of partnership between employer and employee will emerge.