Post-Pandemic Retirement Structures: Worker Equity Pension Protection Program

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What is clear from the recent pandemic events is that existing retirement plan structures are not adequate for government, business or for workers. Future retirement designs need to align government, business and workers. Emergency loans make sense, but it would be nice if retirement designs could handle the next financial crisis.

Options If Bailouts

There have been discussions in Washington, DC that the administration may consider asking for an equity stake from companies that want coronavirus aid from taxpayers. This occurred as a “no other choice step” in the 2008 bailout of General Motors with a favorable result for the government and the employee benefit trusts established for retiree medical benefits (VEBA Trusts) for union workers. However, there are thoughtful approaches that can avoid such action in a crisis.

It may make sense to also require as a condition of such a bailout that workers get an equity stake allocation in the company that gets allocated over a number of years. As part this allocation, another requirement could be that a defined benefit pension be utilized such that it is integrated with the equity benefit to provide a failsafe mechanism so that workers can have a secured retirement benefit. This would initially be a cashless benefit that hopefully continues as such until (if at all) the next financial crisis. Such a structure would limit the amount of government assistance required in the next financial crisis and protect workers so they could have a secure retirement benefit.

The workers could get the greater of the equity value or a floor pension benefit. Such a benefit can be designed as a no cost approach initially and over time only be triggered as a guaranteed minimum pension in the case of a new financial crisis down the road. Diversity features can be added to such a program to minimize worker risk and the need for government intervention. This strategy would align all stakeholders (business, government and workers). 401(k) plans can be integrated with such structure to offer tax advantages and diversity.

Floor-Offset Plan

Under a “hybrid” design called a floor-offset plan, companies can offer equity to workers while integrating it with defined benefit pension plans. By combining the accrual patterns of employee ownership with a pension plan, a floor-offset arrangement can meet the needs of a broader range of employees than either plan standing alone. Under this approach, a 401(k) plan can continue as a supplement to assure adequate retirement savings.

The concept was developed in the early 1970s to provide benefit security to protect employees against an employer’s inability to fund defined contribution plans or defined benefit plans. The employer establishes an Employee Stock Ownership Plan (ESOP) that offsets a defined benefit plan. The floor-offset plan promises to pay the amount calculated by the pension formula offset by the balance in the (newly-created) defined contribution plan or ESOP. If the ESOP balance is greater than the amount promised by the defined benefit formula, the ESOP balance is paid and no further benefits are due. If the ESOP balance is not greater, then the residual amount is paid by the defined benefit plan.

The ESOP or, alternatively, the pension can be designed to be the primary source of retirement income. If the ESOP is intended to be the primary source of retirement income, then the pension plan ensures a minimum benefit if the employer cannot make contributions to the ESOP or if the company goes into bankruptcy. If the pension plan is intended to be the primary source of retirement income, then the ESOP can be structured purely as an offset to the cost of the pension benefit. In a post-pandemic world, equity values should increase substantially.

Floor-offset arrangements accommodate a variety of different objectives. The program can be implemented as a benefit enhancement (with or without company stock), a cost reduction strategy, a broad based employee ownership strategy, an acquisition or disposition financing strategy, pension funding strategy, cash flow and/or cost savings and/or as a strategy to rebalance the defined contribution and defined benefit plan relationship

The floor-offset design can be utilized in many applications with other employer-sponsored plans. For example, a profit sharing plan, including 401(k) matching dollars, can be converted into a floor-offset arrangement with an existing pension plan or new pension plan. However, the offset can only apply with respect to future benefit accruals.

Benefits of Floor-Offset Plan

A floor-offset plan, utilizing an ESOP, can help alleviate current and future pension cash funding obligations. This design lowers cost and helps address funding while preserving the overall pension design. It is also a more efficient use of employer funds or equity during time of distress. Such a design allows for an improvement of cash flow and earnings of a company while providing the opportunity of equity appreciation to employees. ESOP stock funding improves the pension funded status and the appreciation of employer securities would further improve the funded status of pension plans and potentially provide incremental benefits above floor pension benefit.

The floor-offset design can also reduce interest rate volatility. It is able to do so through increasing the overall level of funding and, by extension, the appreciation potential of the defined contribution plan. The floor-offset also provides the economic efficiency of a pension (turnover/mortality), annuity benefits and spousal protections, a portable benefit and employee/labor upside if the business improves.

If designed properly, employees may potentially receive in retirement benefits that could exceed pre-retirement income. It offers a unique opportunity to align, or better align, compensation and benefits costs with competitors (domestically and/or globally).

The introduction of the employer stock feature does not alter defined benefit plan protections, i.e., PBGC guarantees up to statutory limits, remain in force. The investment returns on other, non-employer stock pension investments should have a more material impact on the funded status of the pension plans. If volatility is a concern, some plan assets can be invested in fixed income investment to reduce interest rate volatility. In addition, if the general concept of broad-based employee ownership is important to an employer, the utilization of a floor-offset design to implement that objective can provide employees broad-based, long-term employee ownership with a significant degree of downside protection.

The Challenge

It is time to fully align government, business and workers with durable retirement structures that can align all stakeholders with long-term solutions.

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