

# **Reimagining Pensions**

**The Next 40 Years**

EDITED BY

Olivia S. Mitchell and  
Richard C. Shea

**OXFORD**  
UNIVERSITY PRESS

**OXFORD**

UNIVERSITY PRESS

Great Clarendon Street, Oxford, OX2 6DP,  
United Kingdom

Oxford University Press is a department of the University of Oxford.  
It furthers the University's objective of excellence in research, scholarship,  
and education by publishing worldwide. Oxford is a registered trade mark of  
Oxford University Press in the UK and in certain other countries

© Pension Research Council, The Wharton School,  
University of Pennsylvania 2016

The moral rights of the authors have been asserted

First Edition published 2016

Impression: 1

All rights reserved. No part of this publication may be reproduced, stored in  
a retrieval system, or transmitted, in any form or by any means, without the  
prior permission in writing of Oxford University Press, or as expressly permitted  
by law, by licence or under terms agreed with the appropriate reprographics  
rights organization. Enquiries concerning reproduction outside the scope of the  
above should be sent to the Rights Department, Oxford University Press, at the  
address above

You must not circulate this work in any other form  
and you must impose this same condition on any acquirer

Published in the United States of America by Oxford University Press  
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data  
Data available

Library of Congress Control Number: 2015943025

ISBN 978-0-19-875544-9

Printed in Great Britain by  
Clays Ltd, St Ives plc

Links to third party websites are provided by Oxford in good faith and  
for information only. Oxford disclaims any responsibility for the materials  
contained in any third party website referenced in this work.

## Contents

---

<i>List of Figures</i>	ix
<i>List of Tables</i>	xiii
<i>Notes on Contributors</i>	xv
1. Introduction: Changing Frameworks for Retirement Security <i>Olivia S. Mitchell</i>	1
<b>Part I. Assessing the Retirement System: Adequacy, Efficiency, and Stability</b>	
2. Are Retirees Falling Short? Reconciling the Conflicting Evidence <i>Alicia H. Munnell, Matthew S. Rutledge, and Anthony Webb</i>	11
3. Retirement Plans and Prospects for Retirement Income Adequacy <i>Jack VanDerhei</i>	37
4. The Changing Nature of Retirement <i>Julia Coronado</i>	61
5. Entitlement Reform and the Future of Pensions <i>C. Eugene Steuerle, Benjamin H. Harris, and Pamela J. Perun</i>	74
<b>Part II. New Thinking about Retirement Risk Sharing</b>	
6. Risk Sharing Alternatives for Pension Plan Design: An Overview and Case Studies <i>Anna M. Rappaport and Andrew Peterson</i>	95
7. United States Pension Benefit Plan Design Innovation: Labor Unions as Agents of Change <i>David S. Blitzstein</i>	123
8. Back to the Future: Hybrid Co-operative Pensions and the TIAA-CREF System <i>Benjamin Goodman and David P. Richardson</i>	139

**viii Contents**

9. Retirement Shares Plan: A New Model for Risk Sharing <i>Donald E. Fuerst</i>	161
10. The Portfolio Pension Plan: An Alternative Model for Retirement Security <i>Richard C. Shea, Robert S. Newman, and Jonathan P. Goldberg</i>	174
11. Cultivating Pension Plans <i>John M. Vine</i>	183
<b>Part III. Pension Reform: Lessons from Abroad</b>	
12. The Promise of Defined Ambition Plans: Lessons for the United States <i>A. Lans Bovenberg, Roel Mehlkopf, and Theo E. Nijman</i>	215
13. Insights from Switzerland's Pension System <i>Monika Büttler</i>	247
14. The Australian Retirement Income System: Comparisons with and Lessons for the United States <i>Rafal Chomik and John Piggott</i>	274
15. Singapore's Social Security Savings System: A Review and Some Lessons for the United States <i>Benedict S. K. Koh</i>	298
<i>Endmatter</i>	341
<i>Index</i>	345

## Chapter 7

# **United States Pension Benefit Plan Design Innovation: Labor Unions as Agents of Change**

---

*David S. Blitzstein*

Above all, strong but independent employee representation is required on the governing boards of the pension funds. Both the present job and the future pension are employee interests. Both require guardianship for the employee through his representatives . . . and as a good many American labor leaders learned from New York City, the integrity of the employee's pension fund assets (increasingly the employee's main asset, and his main resource next to his job) needs to be protected. (Drucker 1976: 146)

In the present crisis, unions continue to shoulder their traditional responsibilities of being spokesmen for employees in demanding that economic and political leaders take steps to propel the economy forward. The new question is whether the unions should also accept part of the responsibility of defining the policies, the directions, programs and projects for these ends, so as to help their following attain the desired level of high economic activity, and the rising economic and social well-being to which unions are committed. What steps should they take to discharge these responsibilities competently? (Barkin 1983: 425)

The study of retirement and pension benefit design for the past 30 years has traditionally concentrated on the economics and behavioral features of defined benefit (DB) and defined contribution (DC) delivery systems. Little has been written about the institutions that sponsor and drive the direction of pension benefit design in our society. One institution that has shaped the United States retirement system in the post-World War II era is the labor movement. In fact, labor unions played a key role in establishing DB pensions for millions of workers in the late 1940s. The stage was set by the success and ingenuity of larger-than-life union leaders including Sidney Hillman and John L. Lewis, who established industry-wide multiemployer

## 124 Reimagining Pensions

pension plans in the clothing and coal industries. Their early efforts in achieving collectively bargained pension plans set the pattern for other major industries like steel and auto. By 1950, the United Steel Workers and the United Auto Workers negotiated company pension plans with the major industry employers (Sass 1997).

The US DB pension system was not created in the corridors of Congress. Instead, it emerged from a messy process of labor–management negotiations involving industrial strife, contentious litigation, and threats of government intervention. Peter Drucker (1976) and Solomon Barkin (1983), whose statements introduce this chapter, were prescient observers and commentators on the role of corporations and unions in the twentieth century. Both experts looked beyond pure market economics, to focus instead on the role of institutions to better understand social, economic, and political events and trends. They especially identified with and studied the role of labor unions as economic decision-makers. This chapter focuses on the role that unions have played, and can play in the future, in redesigning the US pension system.

Today, the DB system is in the throes of an existential crisis. Pension plans that organized labor helped create in the mid-twentieth century went into decline after 1980 and were displaced by DC plans. The decline of the DB plan system over this period correlates closely with the decline of organized labor in the US. Moreover, two financial shocks during the first decade of the twenty-first century deeply challenged DB plans' very existence. But if change and Schumpeterian 'creative destruction' are natural outcomes of capitalism, then the questions of how social and economic change is managed and what replaces moribund institutions become worthy of thought and study.

In the next 20 years, the US will experience a transformation of the occupational pension system. How this transition is managed and the form it takes will determine retirement outcomes for much of the American workforce. Even though the US labor movement has been weakened, it is still strategically positioned in a number of high-profile private sector industries and firms. Moreover, unions still play a dominant role in the public sector. This puts labor unions in a unique role to renegotiate the pension social contract in key parts of the American economy.

In this chapter, we relate through a case study how one labor union, the United Food and Commercial Workers International Union (UFCW), sought to manage an ongoing crisis among its collectively bargained multi-employer pension plans by introducing a hybrid plan to replace its traditional DB pension plans. In what follows, we describe the development of that hybrid plan and how it gained influence beyond the UFCW and the industries it represents.

### **Multiple Financial Crises in the 2000s Destabilize the UFCW's Traditional Defined Benefit Plans**

The UFCW is a North American labor union with 1.3 million members in the US and Canada. Its membership predominately works in retail food and food manufacturing, and upwards of 90 percent of its membership is covered by collectively bargained pension plans. Two-thirds of the UFCW membership, mostly in the retail food supermarket industry, participate in DB multiemployer pensions administered by joint boards of trustees equally represented by labor and management. The UFCW and thousands of signatory employers together sponsor 60 multiemployer plans with \$25 billion in assets covering a total of 1.4 million active workers, inactive workers who have earned a non-forfeitable benefit, and retirees. The current ratio of active to inactive participants is about 1:1. UFCW members work in low to moderate wage industries characterized by high turnover and part-time work. The average DB pension benefit is only \$500–\$600 per month, at present. Some long-service career members do receive pensions that are multiples of three to five times the stated pension.

As they entered the twenty-first century, most UFCW multiemployer pension plans were strongly funded using expected return assumptions averaging 7.5 percent. Illusory funding surpluses that emerged during the frothy capital markets of the 1990s were used for benefit improvements including expensive early retirement subsidies. Funding policy discipline waned as bargaining parties agreed to multi-year contribution holidays. Perverse federal tax policy that capped the tax deductibility of employer contributions for fully funded pension plans promoted bad behavior by stakeholders. A herd mentality also drove sponsors to invest aggressively in high volatility growth assets, and 60–70 percent allocations to stock were the norm.

When the Tech Bubble in stocks burst beginning in 2000, DB pensions were unprepared for a 'perfect storm' of asset drawdowns and declining interest rates. Funding ratios dropped by over 30 percentage points, on average, as markets slid for three consecutive years, something not experienced since the market crash in 1973–4. The UFCW's response to these new, gaping funding deficits was multi-faceted. At the fund level, trustees started assessing investment risk more seriously by diversifying portfolios away from public equity. At the bargaining table, labor and management crafted new pension funding agreements that increased employer contributions and reduced future service benefit accruals. A number of these funding agreements had automatic trigger mechanisms that required changes in contributions and benefits based on certain projected actuarial events.

The plans began improving their funding position after 2003, but it became apparent that funding recovery would be slow and that some

## 126 Reimagining Pensions

plans had been badly damaged. Many were projected to trigger the dire regulatory status called ‘minimum funding deficiency’ under the Employee Retirement Income Security Act (ERISA), which would impose onerous lump-sum contributions and surtaxes on employers. These events stimulated a movement to reform the federal pension funding rules, culminating in Congress passing the Pension Protection Act (PPA) in 2006. This was the first major reform of pension funding rules since ERISA became law in 1974 and the Multiemployer Pension Plan Amendments Act (MPPAA) was passed in 1980. The UFCW took an active role in lobbying for PPA, joining the retail food industry employers and the National Coordinating Committee for Multiemployer Plans (NCCMP), the multiemployer community lobbying arm, in an effective labor–management coalition.

The PPA created a range of funding zone certifications for multiemployer plans from ‘safe’ (green zone) to ‘endangered’ (yellow zone) to ‘critical’ (red zone). Plans are required to annually certify their zone status to the Internal Revenue Service (IRS). If a plan certifies yellow zone (<80 percent funded), the plan trustees have 270 days to implement a Funding Improvement Plan (FIP) that returns the plan to financial health within 10–13 years. If the plan certifies red zone (<65 percent funded), the trustees must promulgate a Rehabilitation Plan (RP) that returns the plan to financial health within 10–13 years. Both FIP and RP plans provide direction and funding discipline to the collective bargaining parties. Red zone plans had the ability for the first time under ERISA to reduce or eliminate accrued early retirement and disability benefits for all plan participants except retirees (PBGC 2013).

Pension plans had not yet recovered from the asset drawdowns of the Tech Bubble when they were struck by the devastating shock of the Great Financial Crisis of 2008–09. Many plans lost the equivalent of 30 percentage points of funding in one year, and 70 percent of multiemployer plans certified yellow or red zone in 2009. The funding damage was so dramatic that in 2008 Congress passed an amendment to PPA titled the Worker, Retiree, and Employer Recovery Act (WRERA), which allowed plans to defer actions required under PPA for one year. A second phase of Congressional action in 2010 with the Pension Relief Act (PRA) allowed multiemployer plans to amortize investment losses incurred in 2008–09 over 29 years, in contrast to the fifteen-year period legislated by PPA.

### **The UFCW Assesses the Damage of the Twenty-First-Century Pension Crisis**

The UFCW reacted aggressively to these financial threats by conducting an internal review and critique of its pension plans unconstrained by prior



**Labor Unions as Agents of Change 127**

beliefs or union politics. The union's response was somewhat unique due to two institutional advantages. First, it had created an internal staff capability and expertise to advise the leadership on all matters related to pensions and health insurance. Secondly, the union leadership, to its credit, had the confidence to objectively evaluate bad news and consider unconventional solutions that would resolve serious problems undermining the benefit security of its membership.

In early 2006, in anticipation of PPA legislation, the union conducted a funding analysis of its plans by applying a number of Pension Benefit Guaranty Corporation (PBGC) funding and solvency screens to measure plan sustainability. The results were sobering. Two-thirds of the UFCW's plans triggered two or more of the PBGC's screens, and more than a third of the UFCW's plans were less than 70 percent funded. Just as troubling, a number of UFCW funds that had been fully funded in 2006 were now projected to have minimum funding deficiency problems in 10 years or fewer, and they could be expected to trigger yellow or red zone status in four to five years based on draft PPA legislation.

At the same time that the UFCW was conducting its internal pension study, a number of accounting, financial, and regulatory pressures were being felt. The Financial Accounting Standard Board (FASB) proposed new rules that would have required multiemployer plan corporate sponsors to report unfunded liabilities on their income and balance sheets at market value using risk-free rates, instead of the plan's discount rate. In addition, credit rating agencies like Moody's and Standard & Poor began to research multiemployer plan sponsors and industries, highlighting the growth in off-balance sheet pension debt by firm and industry (Moody's 2006). Concurrently, Congress tripled multiemployer plan premiums to the PBGC, which was itself experiencing growing deficits, and required plans to report a current liability funding ratio based on annuity rates that suggested even weaker funding ratios for plans.

This confluence of events served as the background to the internal UFCW pension study presented to the union's leadership in spring 2006. The report raised for the first time a series of difficult policy questions for the UFCW's leadership. One was whether UFCW multiemployer plans were financially sustainable, and what the cost of plan sustainability might be. Another focused on whether signatory employers could afford this cost given the competitive environment. Additionally, the report asked what the ramifications of the pension crisis for the stability of the UFCW's collective bargaining system might be, focusing on the economic trade-offs for the union and its members. Reviewing the options in light of the pension crisis, and assuming pension benefits could be frozen for a generation, raised questions about the economic consequences for members' retirement incomes. And crucially, if a union deemed its current plans to be

## 128 Reimagining Pensions

unsustainable, the question arose as to what alternative plan designs might be considered.

These policy questions raised a series of political dilemmas for the UFCW, which also became the subject of discussion. Questions arose about how the membership and local union leaders might respond to the pension crisis, and whether the membership might internalize its fear and anger against the union leaders. Additionally, leaders worried that the UFCW and its sponsored plans might be subject to litigation. Naturally, questions were raised about whether the membership would support a strategy by the union to reform and redesign its plans. Of course, any reform would raise the issue of how the union would manage intergenerational equity issues as pension benefits became more differentiated between demographic groups based on when they began working in the industry. And finally, there were concerns that pension plan failures might inhibit the UFCW's ability to organize and attract new members.

After assessing the political risks, the UFCW leadership opted for a proactive, solution-based approach to the pension crisis, deciding that the status quo was more dangerous than renegotiating a new pension contract.

### **The Question of DB Plan Sustainability**

The pension crisis that started in the first decade of the twenty-first century coincided with a number of emerging structural trends synonymous with the maturing life cycle of these plans, many of which were 50–60 years old. Plan demographics had changed dramatically due to stagnant union growth and the impact of technological change. The absolute number and growth of retirees each year exceeded additions to the active worker population, which was the basis for employer contributions. Active pension participants were now supporting one to two inactive participants, a reversal from earlier decades when the plans were new and growing (Kocken 2011).

These demographic trends generated net negative cash flows to the DB plans, with annual benefit and administrative payments exceeding annual employer contributions. Not surprisingly, this created a drag on asset growth and an additional burden on expected investment returns. Additionally, negative cash flows were projected to nearly double over the next decade, in a number of UFCW plans.

Another characteristic of mature DB pensions is that they become quite dependent on investment income, making the plans particularly sensitive to investment return volatility. Investment income in mature pension plans accounts for 70–80 percent of total annual income. And as many DB plans discovered in the last decade, investment volatility can dramatically affect the plan's funding balance. As the assets of mature pension plans grow, they

## Labor Unions as Agents of Change 129

become even more vulnerable to the rule of large numbers. A 10 percent drawdown on \$1 billion is 10 times that on a \$100 million asset base. Larger pension plans are also highly leveraged, with assets equal to multiples of 30–50 times contributions. This makes it nearly impossible to recover from large asset drawdowns by increasing employer contributions.

Modern portfolio theory failed the DB pension system during the first decade of the twenty-first century. Pension portfolios that were assumed to be highly diversified, turned out to actually be highly correlated with public equity risk and therefore vulnerable to major asset declines. The secular decline in interest rates compounded the perfect financial storm facing pension plans. In reaction to the threat of depression, extraordinary monetary policy exercised by the Federal Reserve sent interest rates even lower, adding to the investment pressures on pension plans. DB pensions with long liability durations faced challenging asset liability mismatches, when long bond rates were below 4 percent. At the same time, the situation created perverse incentives for plans to take more investment risk than they could manage, in an effort to earn expected returns of 7–8 percent. The mature DB pension model became hypersensitive to capital market volatility: a few years of negative returns destroyed a decade of asset growth and defunded once-healthy DB plans, driving many into a death spiral.

### **Inspirations for Benefit Design and Governance Innovation**

This structural analysis of traditional DB plans convinced the UFCW that the sustainability of their pension system was at risk, requiring it to search for alternatives. This was in keeping with its history of innovating in the pension arena. In 1984, the UFCW National Pension Fund took advantage of high interest rates and eliminated its unfunded liabilities by purchasing an annuity from MetLife for the plan's past-service liability at highly favorable prices. That transaction allowed the plan to restart the fund as a future-service-only plan. Groups differentiated by area and industry were experience-rated separately based on their individual demographics, but they continued to share investment and administrative experience. The new future service plan was conservatively funded through a regimented process where the plan recalculated the actuarial cost of benefits every two to three years and required the collective bargaining parties to reset contributions given the updated costs. This structure gave the plans a DC-type quality, where labor and management determined the contribution/benefit formulas that fit their special market conditions. This unique funding/benefit system, with its self-adjusting mechanisms, was a major reason why the UFCW National

### 130 Reimagining Pensions

Pension Fund remained fully funded and retained a PPA green zone status throughout the crisis.

Another example of UFCW design/governance creativity was seen with a plan sponsored by UFCW Local 1518 in British Columbia, Canada. The trustees of that multiemployer plan foresaw the secular decline in interest rates in the 1990s, and they made a politically courageous decision to move away from a model that measured liabilities based on expected returns to one that targeted liabilities to certain market interest rates. Instead of spending transitory surpluses on benefit improvements during the mid-1990s, the Local 1518 Plan adjusted its benefit liabilities to market interest rates and adopted a highly effective liability driven investment program that maintained a fully funded status despite the storms of the first decade of the twenty-first century. The experience of the UFCW Local 1518 Plan suggested a viable investment risk management model worth emulating.

An important influence on UFCW staff was its consultations with Keith Ambachtsheer, an internationally recognized pension strategist and big-picture thinker. Ambachtsheer conceived of DB plans as complex risk sharing arrangements, and he devised rules of the ‘pension deal’ based on a contractual model where terms must be clear and transparent (Ambachtsheer 2007). His view that risk sharing must be fair and symmetrical provided a theoretical framework for the UFCW to benchmark its ideas for building a hybrid plan. The Ambachtsheer principles of a clearly stated targeted pension benefit, a clearly stated expected cost of delivering the target benefit, a clearly stated risk-bearing deal between the various stakeholder groups, and a clear statement about how risk would be managed within the pension plan, formed the philosophical building blocks for the UFCW benefit design. In addition, Ambachtsheer’s work with leaders in two of the world’s most successful retirement systems, the Canadian and Dutch, offered best practice insights into achieving optimum governance and benefit design.

The UFCW was also influenced by the 2006 introduction of a ‘Retirement Shares Plan’ (RSP) conceived by Don Fuerst and Mercer Consulting (see Fuerst 2015). The RSP was a form of Variable Benefit Plan established by IRS Revenue Rulings in the 1950s, which allowed accrued benefits to vary based on plan investment performance. Variable Benefit Plans fell out of favor after the 1973–4 market crash, when these plans had no choice but to enforce severe cuts in retiree benefits. One important Variable Benefit Plan that did survive is the Pension Plan of the Major League Baseball Players. RSP is similar to a DB career accumulation pension: a percentage of each year’s pay is used to buy retirement shares at the year-end purchase price of the shares. The benefit earned each year then varies with investment performance. The employee can change the investment mix each year and adjust his individual risk. At the normal retirement age, the employee

**Labor Unions as Agents of Change 131**

receives an annual retirement income based on the number of retirement shares accumulated over his working life. During retirement, annual income also varies with investment performance (Fuerst 2006). The RSP risk sharing approach became a model for the UFCW benefit design project.

**Deciding on Pension Design Priorities: The UFCW Evaluation Process**

The UFCW constituted a team of pension experts, including legal experts, actuaries, and pension investment consultants, to research and develop a new hybrid design from late 2006 through 2009. In early deliberations, the UFCW pension task force (the Committee) began formulating its goals and objectives. A substantial part of this discussion focused on pension legacy issues and how to transition to a new pension system. While these legacy and transition issues are critically important, they are not the subject of this chapter (see Blitzstein 2013).

The Committee began its work by rejecting the traditional DB and DC models. The UFCW's concerns about the recurring structural flaws in the traditional DB plan were as already described. The financial crisis had effectively exposed the myth that all investment risk in DB plans could be absorbed by employers, since participants' experience with multiple rounds of pension benefit reductions suggested otherwise. At the same time, the UFCW recognized the various risks facing corporate plan sponsors. Changes in pension accounting rules, the opinions of credit rating agencies, and the ability of firms to withstand the balance sheet volatility of DB pension liabilities had to be recognized by the UFCW in its new plan design exercise. Avoiding the risk of generating new unfunded pension liabilities became a priority in the UFCW design exercise.

The Committee considered adopting 401(k) plans, but these were rejected because their design imposed unacceptable risks on workers and retirees. These plans' direct shifting of investment, mortality, and retirement risk to participants ruled them out. The Committee was also suspicious of the behavioral economics foibles relevant to DC plans, regarding participant contribution and investment decisions. In addition, the low-to-moderate wage levels in the industries represented by the UFCW raised questions about whether DC plans could generate affordable and adequate retirement benefits. A further consideration was DC plans' inability to provide early retirement options, disability benefits, and lifetime annuities.

Similarly, the Committee also rejected cash balance plans as these did not offer an equitable alignment of risk between employees and employers. In particular, employees gained no upside investment opportunity, and employers were still at risk for investment downturns. The fact that annual

### **132 Reimagining Pensions**

floor accruals decrease with age also presented the UFCW with concerns about intergenerational conflicts among its membership. Another problem was that cash balance plan forfeitures from turnover automatically reduced employer costs, instead of remaining in the plan asset pool. A final negative regarding cash balance design was these plans' emphasis on lump sum payment at retirement instead of lifetime annuities.

This exercise of evaluating existing plan designs was valuable because it focused the UFCW's efforts to build its own customized retirement model. While the Mercer Retirement Shares Plan did offer some useful aspects, it did have some features that were contrary to UFCW's goals and principles. For example, the UFCW rejected the concept of employee investment choice within the risk-sharing structure of RSP, and so it did not adopt the RSP benefit variability feature for retiree benefits.

The internal discussion produced a new plan set of design goals, which included the following:

- Benefits should be fairly priced using interest rates more representative of long-term historic interest rates.
- The new plan design had to be structured in a way that aggressively managed investment risk.
- The new plan design had to support stable employer contributions, along with a high probability of plan full funding.
- The stakeholders should expect the plan design to meet regulatory standards and scrutiny.
- The new plan design had to be matched with an effective and disciplined governance model.
- Pension benefit payments would be paid in the form of lifetime guaranteed annuities.
- The new plan design had to deliver on the contractual pension promise.

### **The Mechanics of the UFCW Variable Defined Benefit Plan Take Shape**

The UFCW hybrid plan design had taken on form and structure by the end of 2007. The Committee referred to its creation as the Variable Defined Benefit Plan (Variable Plan); it later became known as the Adjustable Pension Plan (APP). This plan was structured like a DB in that retirement and longevity risks were pooled, and all assets were pooled and managed professionally. But in contrast to a DB plan, the Variable Plan shared positive and negative investment performance between the employer and plan participants. The Variable Plan benefit is defined as the greater of two benefits calculated separately each year: a 'floor' defined benefit (that can

**Labor Unions as Agents of Change 133**

be either a flat benefit accrual or salary-based career average formula), and a 'variable' benefit that fluctuates depending on actual investment performance. Each year's benefit accrual can never be lower than the floor benefit.

The floor benefit is priced using a 'floor interest rate' plus plan demographics. An initial floor benefit was modeled to be \$600 per year (the equivalent of \$50 per month per year of service). The floor accrual does not change due to plan investment experience. However, the Variable Plan design anticipated that the floor benefit accrual could be sensitive to changing plan demographics and would have to be recalibrated periodically. The floor interest rate is also the performance benchmark for the variable benefit. The Variable Plan design envisioned setting the floor interest rate at 4.5–5 percent, a rate 30–40 percent lower than the expected return rates used by multiemployer private and public plans. The basis for the floor interest rate was long-term corporate interest rates (of 20–30-year maturity). The median corporate interest rate over the period 1919–2007 was 5.25 percent and the 25th percentile was 3.75 percent. In 2007, the average corporate long term rate was priced at 4.7 percent.

The variable benefit accrues in units (similar to RSP shares). Start-up unit values are set at an arbitrary level (e.g. \$10.00 per unit). Unit values are adjusted each year based on actual investment returns compared to the floor interest rate benchmark. Every year, the units earned equal the floor accrual divided by unit value at the beginning of the year (e.g. units earned = \$600 divided by \$10 = 60 units). The variable benefit is then equal to the number of units times the unit value. This structure is important because, in combination with the floor benefit, it complies with the definitely determinable benefit accrual rules of ERISA, and it also allows for variable benefit changes year to year. In effect, participants are accruing units rather than benefit dollars.

With regard to the variable benefit, the Committee created two rules for surplus management, for the purpose of safeguarding plan funding. These were as follows:

- Any surplus return in excess of a designated percent (e.g. 7–10 percent) would be capped ('Surplus Cap') and not applied to the variable benefit. These excess returns would become a reserve or margin that would be available as a contingency against future negative investment performance.
- Excess returns earned below the Surplus Cap would be applied to the variable benefit by increasing unit values or units held (not by increasing the floor accrual rate). This approach does not increase the member's ultimate benefit, and as a result does not increase the employer's risk for unfunded liabilities. Issuing additional units provides the greatest flexibility for allocating excess returns through the variable benefit.

### 134 Reimagining Pensions

The Committee also applied the lessons of asset/liability leverage in maturing plans discussed earlier, to the payment of retiree benefits. A Variable Plan would establish a policy that required the plan to annuitize or immunize all retiree payments when they became effective. The goal was to insure the retiree liability as best as possible, and to ensure that large asset/liability mismatches would not occur; additionally, the intent was to preclude retiree liabilities from dominating the plan's balance sheet over time.

The Committee devoted much of its limited budget to testing the financial robustness of the Variable Plan. Two Canadian consulting firms with insurance liability modeling capabilities were asked to recommend the most efficient investment strategy to deploy in order to meet the Variable Plan objectives. The Committee had two objectives: to achieve a minimum return of 5 percent each year with a risk parameter that anticipates a low standard deviation of 5 percent; and to seek an excess return above 5 percent without impairing the first objective. After running a number of optimal asset allocation strategies, the Committee selected a beta-test asset allocation scenario that consisted of 5 percent cash, 36 percent investment grade bonds, 8 percent below-investment grade bonds, 15 percent inflation-linked bonds, 25 percent hedge funds, 10 percent real estate, and 1 percent commodities. When back-tested within the limitations of historic financial information and capital market assumptions, this asset allocation portfolio generated a 6.83 percent return with a standard deviation of 3.54 percent. Using the most recent highly volatile period 1998–2009, the portfolio returned on average 6.64 percent, including –5.96 percent in 2008, but with all other years returning above 5 percent. The Committee enhanced this strategy by adding a cash-matching Liability Driven Investment (LDI) strategy that matched the plan's projected liability cash flows each year for the next 20 years of liabilities. Stochastic modeling results suggested that this combined strategy would generate plan surpluses consistently, allowing a variable benefit upside.

The Committee was satisfied that it had created the appropriate policies and funding safeguards for the Variable Plan that fulfilled the original objectives and principles for introducing a hybrid plan to its affiliate local union officers. This DB floor was priced conservatively, with upside benefit potential controlled by a surplus return cap, and with funding risk managed by a flexible unit value benefit system and complimented by a low volatility investment strategy anchored by LDI cash matching liabilities.

The Committee also discussed what could possibly go wrong with the model, and it determined that the one uncontrollable factor in the future of the Variable Plan pertained to governance and policy discipline. The ultimate question was whether pension boards of trustees could break with the conventional pension investment and governance practices of the past, so as to instead adopt and enforce policies unique to the Variable



**Labor Unions as Agents of Change 135**

Plan. The Committee was convinced that it could not legally bind boards of trustees to the original policy rules of the Variable Plan. Only continued trustee education and institutional memory could secure the future.

**The UFCW Takes the Variable Plan Public**

In January of 2009, the UFCW presented the Variable Plan for the first time to the employer members of the Joint Labor Management Committee of the Retail Food Industry (JLMC). Established in 1974 by the organized supermarket companies along with the UFCW and the International Brotherhood of Teamsters (IBT), the JLMC provides a forum for union and company officers to discuss strategic public policy and collective bargaining issues. In a presentation about the pension crisis, the UFCW introduced the Variable Plan concept as a potential solution for the industry. The employers were impressed with the union's directness and the proactive nature of the presentation. After the meeting, the Kroger Company, the largest employer of UFCW members, invited the UFCW to present its analysis of the pension crisis and the Variable Plan to its February 2009 conference of Kroger trustees.

At the same time, the UFCW leadership mobilized an internal education campaign to address solutions to the pension crisis. Presentations were made to the UFCW's two most important governing bodies, the UFCW Executive Board consisting of 50 vice presidents, and the Local Union Advisory Committee which accounted for about 80 local unions and councils not already represented on the Executive Board. The UFCW local union leadership was receptive to the Variable Plan idea and appreciative that the UFCW leadership and staff were taking the initiative by actively seeking practical responses to the pension crisis. In May of 2009, the UFCW held a one-day 'Pension Summit' for union trustees, at which the Variable Plan was showcased and described in detail. Keith Ambachtsheer, Director of the Rotman International Center for Pension Management at the University of Toronto, was a guest speaker and offered expert guidance and support to the UFCW's efforts to renegotiate its pension contracts and establish the new, more sustainable pension design model. During the conference, UFCW trustees responded positively to the Variable Plan. Consensus support developed in favor of advancing the Variable Plan idea and beginning a dialogue with employers.

Throughout 2009–10, the UFCW met with its largest employers to present the Variable Plan. In 2011, Kroger and the UFCW began a serious discussion about restructuring four multiemployer plans covering 180,000 participants, where Kroger was the dominant contributing employer (Blitzstein 2013). All four plans were underfunded and certified red zone plans. Kroger was

### **136 Reimagining Pensions**

receptive to the UFCW strategy of issuing public debt to accelerate funding of the legacy pension deficits, with a cost of bringing these merged plans to full funding of nearly \$1 billion. The UFCW pressed for the adoption of the Variable Plan, but Kroger rejected the hybrid plan because of the uncertainty of the Variable Plan's regulatory status and the cost of replicating current benefits using lower interest rates required by the Variable Plan. Ultimately, the UFCW and Kroger reached an historic pension deal effective January 1, 2012, with a new pension contract creating the UFCW Consolidated Fund. This would be 10 years in duration, merge the four plans, prohibit benefit reductions during the contract term, establish a new salary-based future service plan that targeted an agreed-to replacement income, and commit Kroger to fully funding the plan and keeping it green zone under PPA through 2022.

While the first attempt to introduce the Variable Plan failed, the effort served a purpose by giving the UFCW a level of bargaining leverage and credibility with Kroger and other employers, supporting the union's goals in stabilizing four underfunded plans. Under the new pension deal with the UFCW, the union conceded its fiduciary authority over the Consolidated Fund's investment policy. In contrast to the beliefs of the UFCW and many pension experts, Kroger argued that it could manage the investment risk of a traditional DB; the firm was also confident that its strong cash flow and balance sheet could absorb the investment risk of the Consolidated Fund. The ten-year UFCW/Kroger pension contract will test Kroger's theory and resolve.

### **The Variable Plan Model Gains Acceptance outside the UFCW**

The Variable Plan has continued to gain attention in pension policy circles and with the labor movement. It was presented to conferences sponsored by the Pension Rights Center, as well as the Pension 20/20 Research Initiative led by the Society of Actuaries (SOA). Several unions made inquiries about the Variable Plan and a number of collectively bargained plans outside the UFCW have adopted the Variable Plan. For instance, Variable Plans were established by Hotel & Restaurant Local 26 in Boston, Massachusetts; the Masters, Mates, and Pilots in Baltimore, Maryland; the Newspaper Guild (an affiliate of the Communications Workers of America) with both the New York Times and the Consumers Union; and the Sheet Metal Workers' National Fund. In addition, the Maine Public Employees Retirement System enacted legislation to adopt the Variable Plan for new hires from 2015.

The Variable Plan has also gained attention in other circles. The National Coordinating Committee for Multiemployer Plans (NCCMP), the lobbying

## Labor Unions as Agents of Change 137

arm of the multiemployer community, presented Congress with a set of proposals to reform the multiemployer pension system in 2013. These proposals were based on the work of the Retirement Security Review Commission which recently published its findings (see DeFrehn and Shapiro 2013). The section of the Commission study that promoted ‘innovation’ proposed that the Variable Plan be formally added to the IRS code. Additionally, in Congressional hearings, the Variable Plan has gained a number of endorsements from Congressional leaders and staff.

### Conclusion

The US occupational pension system has experienced a painful and disruptive decade. The retirement paradigm that emerged after World War II is disappearing in the private sector, and it faces political and financial challenges in the public sector. Recent Boeing/IAM negotiations in Seattle as well as the Detroit bankruptcy provide further evidence of the unraveling of the pension deal. The transition from the old to a new pension order has been underway since 1980, accelerated recently due to major economic and financial crises. The future retirement security of tens of millions of American workers and retirees is in the balance.

While conventional economic theory often ignores or minimizes the institutional role of unions and other pension stakeholders in the private and public pension system, this case study of how unions approached the retirement challenge will help determine the course of history for much of the aging workforce. Constructing a fair and equitable pension deal can be successful, as illustrated here. Jim Leech, the CEO of the Ontario Teachers’ Pension Plan, has recently highlighted the role that labor unions have played in transforming pension plans in New Brunswick, Canada, and the Netherlands (Leech and McNish 2013). The US labor movement, along with other pension stakeholders, has an historic opportunity to revive the pension contract in America.

### References

- Ambachtsheer, K. P. (2007). *Pension Revolution*. Hoboken, NJ: John Wiley & Sons, Inc.
- Barkin, S. (1983). *Worker Militancy and its Consequences*. New York: Praeger Publishers.
- Blitzstein, D. S. (2013). ‘Restructuring Occupational Pension Plans in Crisis: A U.S. Labor Management Case Study.’ *Rotman International Journal of Pension Management*, 6(1): 12–19.
- DeFrehn, R. G. and J. Shapiro (2013). *Solutions Not Bailouts: A Comprehensive Plan from Business and Labor to Safeguard Multiemployer Retirement Security, Protect Taxpayers and Spur Economic Growth: A Report on the Proceedings, Findings and Recommendations of the Retirement*

### 138 Reimagining Pensions

- Security Review Commission of the NCCMP*. Washington, DC: NCCMP. <<http://www.nccmp.org/forEmails/SolutionsNotBailouts.pdf>>.
- Rucker, P. F. (1976). *The Unseen Revolution*. New York: Harper & Row Publishers.
- Fuerst, D. E. (2006). 'Risk Allocation in Retirement Plans: A Better Solution.' *Journal of Applied Corporate Finance*, 18(1): 95–103.
- Fuerst, D. E. (2015). 'Retirement Shares Plan: A New Model of Risk Sharing,' in O. S. Mitchell and R. C. Shea (eds), *Reimagining Pensions: The Next 40 Years*. Oxford: Oxford University Press, 161–73.
- Kocken, T. (2011). 'Why the Design of Maturing Defined Benefit Plans Needs Rethinking.' *Rotman International Journal of Pension Management*, 4(1): 44–50.
- Leech, J. and J. McNish (2013). *The Third Rail*. Toronto: McClelland & Stewart.
- Moody's Investor Service, Global Credit Research (2006). *Multiemployer Pension Plans: Moody's Analytical Approach—Rating Methodology*. New York: Moody's.
- Pension Benefit Guaranty Corporation (PBGC) (2013). *Multiemployer Pension Plans, Report to Congress Required by the Pension Protection Act of 2006*. Washington, DC: PBGC. <<http://www.pbgc.gov/documents/pbgc-report-multiemployer-pension-plans.pdf>>.
- Sass, S. A. (1997). *The Promise of Private Pensions*. Cambridge, MA: Harvard University Press.