

# RETIREMENT PLANNING IN UNCERTAIN TIMES...

With Comments by:

Christopher M. “Kip” Condon  
President and Chief Executive Officer  
AXA Financial, Inc.

William D. Degnan  
Senior Vice President  
At Retirement<sup>SM</sup>  
AXA Equitable

Olivia S. Mitchell  
The International Foundation of Employee  
Benefit Plans Professor of Insurance and  
Risk Management at The Wharton School  
Executive Director, Wharton’s Pension  
Research Council  
Director, Boettner Center for Retirement  
Research

*It Shouldn’t  
Be a  
Gamble.*

AXA Advisors’ Whitepaper,  
written in partnership with the  
Wharton School, regarding the  
Pension Protection Act’s potential  
impact on pension plan participants.



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According to the U.S. Census Bureau, the nation currently hosts an estimated 78 million baby boomers. As they begin to retire, many may face a perfect storm of economic turbulence that could batter their finances. They’re expected to live longer than their parents, and their savings tend to be lower than those of previous generations even though their housing, medical care and other costs during retirement will be much higher.

In August 2006, President Bush signed the Pension Protection Act into law, positioning it as a way to improve the existing pension system while expanding opportunities to build retirement nest eggs. It’s a good first step, say experts from Wharton’s Pension Research Council (PRC) and from the AXA Group, a global financial services company.

“Insurance companies are uniquely positioned to address this retirement dilemma,” says Christopher M. “Kip” Condron, President and Chief Executive Officer AXA Financial, Inc. “To help beat inflationary drag on retirement income, we offer a variety of annuity products now that are more sophisticated and offer more benefits than those from 10 years ago. The new generation of annuities gives contract holders a great deal of flexibility. Americans who are at or near retirement can customize the living benefits that best match their needs and goals.”

Wharton professors and others add that pension plan participants and sponsors alike will likely be scrambling to meet with their advisors. “Something had to be done about the pension system and employee participation,” says Olivia S. Mitchell, executive director of the PRC and a Wharton professor of insurance and risk management. “The baby boomers face a situation that’s very different from the one that previous generations had to contend with. The risks are much greater and the uncertainties are terrific, particularly the concern that many baby boomers may outlive their savings.”

Mitchell says the new pension rules will directly affect participants and employers. “The changes, which will be phased in over the next few years, will prompt employers and plan sponsors to review and revisit their existing plans to ensure they’re still compliant,” she says. “Many employers are likely to see an increase in their funding obligations.”

One dramatic effect involves interest rate assumptions. For some retirement plans, the new Act will gradually adjust the rates that are used to compute the conversion of accrued benefits to a lump sum for distribution purposes. Previously, relatively low 30-year Treasury rates were used in present-value calculations,” she says. “The new rules mandate the use of higher, corporate-debt rates.” Because higher interest rate assumptions generate lower lump-sum amounts, Mitchell says this requirement will bring the computations in line with long-term market rates, reducing what she terms an “implied subsidy” that results from the current conversion tables.

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“One of the hallmarks of the pension Act is that it curtails many of the accounting gimmicks that were used to smooth over, or to essentially disguise, defined-benefit plan shortfalls,” notes Mitchell. “Severely under funded, or at-risk plans raise special concerns, because if they’re terminated, participants may lose a significant portion of their benefits. Taxpayers in general may be at risk as these terminated plans are loaded off to the financially strapped Pension Benefit Guaranty Corporation.”

As of September 30, 2005 the Pension Benefit Guaranty Corp--a federal corporation that guarantees the pensions of nearly 44 million American workers and retirees in 30,330 private single-employer and multiemployer defined benefit pension plans—reported a deficit, or excess of liabilities to assets, of \$22.8 billion, according to the agency's annual Performance and Accountability Report that was submitted to Congress.

“Under the new Act, a pension plan will generally be considered to be at risk if its funded percentage for the preceding year is less than 80 percent,” says Mitchell. A transition rule reduces the 80 percent threshold to 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010. “The Act institutes a number of special rules for at-risk, or ‘endangered’ plans that phase in an increase to the minimum required contribution, and that impose additional PBGC reporting.”

If a multiemployer plan is less than 80 percent funded and has (or, in the next six years is projected to have) an accumulated funding deficiency it is considered to be “seriously endangered.” And subject to current funding level and other factors, a plan will be considered “critical” if projections indicate it will fail to satisfy minimum funding standards or will become insolvent within a period of three to six years. “Plans that are endangered or seriously endangered will have to increase their contributions and reduce their benefits,” says Mitchell. “This is designed to eliminate, over proscribed periods, one-third of the under funding in an endangered plan or one-fifth of the under funding in a seriously endangered one.”

“Research indicates that the financial position of baby boomers as they stand on the verge of retirement is about the same as previous generations, on average,” Mitchell notes. “Despite this, they face much greater uncertainty.”

“We live in an era where we all need to be focused on our own retirement needs,” says Bill Degnan, Senior Vice President of At Retirement<sup>SM</sup> for AXA Equitable. “The companies we work for can be a part of that, but financial security is an individual responsibility and a company pension and retirement plan may not be sufficient in getting you there.”

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Degnan continues, “as boomers approach retirement, they will likely be faced with numerous financial decisions that need to be made simultaneously — some may be irrevocable. It is important for them to take the time to learn about the financial vehicles and strategies available to them.”

Mitchell adds that while their parents' generation counted on the cushioning effect of Social Security, today's boomers on the verge of retirement are aware that the program is running short of financing. Further, the previous generation received the benefit of a huge run-up in the value of their homes. But she says that many boomers bought their homes at the higher end of the market cycle, and the future of the real estate market remains unpredictable.

Degnan points out that less than half of U.S. workers aged 55 and above have any idea how much income they will have in retirement, according to AXA's 2007 Global AXA Retirement Scope survey. Moreover, most Americans don't get around to planning until they have missed a significant portion of their working years: 26% of people began planning for their retirement between the ages of 45-54, while 32% didn't start planning until they were 55 or older.<sup>1</sup> “Boomers need to seek the assistance of trained financial professionals when they examine potential sources of retirement income, including mutual funds, individual retirement accounts, pension plans, Social Security, full-time or part-time employment, and other options,” says Degnan. “If there is a gap between the income and the expenses that consumers expect to face in retirement, a financial professional can help them find strategies to fill it.”

“The new pension Act reflects the move away from traditional defined benefit plans, under which the employer basically guaranteed a rate of return,” adds Mitchell. “Today the trend is toward 401(k) plans and hybrid designs that shift the risk to employee/participants. The Pension Research Council and others have long suggested that an automatic opt-in feature, where an employee enrolls in a retirement plan by default and must request exclusion from it, could represent an effective way to get more people into retirement plans. Fortunately the legislature designed the new pension ACT with safe harbor provisions that remove many legal uncertainties about opt-in provisions.”

Besides making it painless to enroll in a defined contribution plan, the new Act is designed to encourage participants to diversify their investments. “One of the issues in recent corporate accounting and other scandals involved inappropriate investment advice by plan sponsors,” notes Mitchell. “In some cases, participants were encouraged to overweigh their investments with their company's stock. But that meant their nest eggs were devastated when their company's stock plunged.”

<sup>1</sup> AXA's 2007 Global AXA Retirement Scope Survey

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In the wake of these issues, plan sponsors retreated from offering investment advice, but Mitchell says this had an unintended consequence—participants tended to cluster their investments around assets that had little risk, but very low yields. “To encourage more balance, defined contribution plans that hold publicly traded employer securities will now be required to permit participants to diversify their investments,” says Mitchell. With these abuses in mind, the Act does limit the ability of an employer to require a plan to invest in employer stock; it also reduces restrictions on plan investments and certain prohibited transactions; and it permits certain small employers to create linked 401(k) and defined benefit plans.

Mitchell says the new pension Act will also make it easier for participants to fund their health benefits. “Section 420, the Internal Revenue Code that addresses transfers of excess pension assets to retiree health accounts is being expanded to allow a pension plan with excess assets to earmark the assets to the payment of future retiree health benefits,” points out Mitchell. “Under current law, the surplus plan assets can only be used to pay for current-year retiree health benefits.” She adds that, beginning in 2010, the Act will allow tax-free distributions from annuities to pay for long-term health care coverage. Tax-free conversions of other types of insurance products into annuities with long-term care riders will also be permitted.

While the provisions of the new Act liberalize rules for most participants, some may find that their options have been narrowed. “In certain circumstances, the new rules will curtail the ability of an employer to set aside assets in a trust or other arrangement to fund nonqualified deferred compensation for the company’s top five executive officers,” says Mitchell. “The periods include any time that the employer’s defined benefit pension plan is considered at risk; a period during which the employer is in bankruptcy; and the 12-month period beginning six months before the termination of an under funded plan.”

The executive will be taxed on any amounts that are set-aside in violation of these rules, or any amounts that are subject to provisions that they will be set-aside in the prohibited circumstances. Additionally, if an employer provides a tax gross-up payment to defray the executive’s tax liability, the amount provided will be treated as deferred compensation subject to a 20 percent additional tax. Under the Act, these gross-up amounts will not be eligible to be treated as a deduction by the employer. She says the new Act also takes bold steps to help resolve major issues that have surrounded hybrid pension plans, such as cash balance plans.

A hybrid plan is a defined benefit plan that retains a primary feature of a defined contribution plan—deemed individual employee accounts—while leaving investment risk and reward with the employer. “Under the most

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common type of hybrid plan, a cash balance format, a participant’s benefit is computed as the balance of a hypothetical account that has been credited with annual contributions—usually a percentage of salary—and investment earnings at a rate that’s specified in the plan,” says Mitchell. “But while a true defined contribution plan allocates its actual investment earnings to participants’ accounts, a cash balance plan allocates returns above or below the specified rate to the benefit or detriment of the employer.” The way that benefits accumulate marks a key difference between a traditional pension formula and a hybrid formula.

Under a traditional plan, benefits accrue relatively slowly in the early years of participation, because they represent a commitment to pay a fixed annuity beginning at the plan’s normal retirement age. Because the payment is relatively distant, the present value of the benefit is relatively low. As a result, the bulk of the value of a traditional pension is back loaded and will accumulate in the later years of service.

But under a hybrid plan, the value of a participant’s benefit for any particular year is not related to the time until retirement. Therefore, benefits accumulate at a steadier rate as compared to a traditional formula. So if a hybrid and a traditional plan provide equal benefits at a specified retirement age, a participant who leaves before that age will do better under the hybrid plan.

“Given today’s mobile work force, many companies believe that hybrid plans are more attractive,” says Mitchell. “The hybrid design also appeals to employers, since funding requirements are less dependent on interest rate assumptions and are generally less volatile than a traditional plan. They also permit portability of benefit accumulations from one job to another.”

As a result, in the 1990s, it was common for many employers to convert their benefit formulas from traditional final average pay formulas to deemed account balance<sup>2</sup> formulas. But the trend was halted by litigation alleging that the reduction in benefits for older workers constituted age discrimination. Some unfavorable court decisions and an IRS moratorium on the issuance of determination letters for hybrid plans essentially halted their adoption. Under the new pension Act however, hybrid plans that meet certain requirements will be protected against challenges under IRS’ age discrimination rules, the Employee Retirement Income Security Act of 1974 (ERISA), and the Age Discrimination in Employment Act (ADEA).

“There’s no question that boomers will witness detrimental changes in the solvency of Medicare and Social Security,” says Mitchell. “And there’s no

<sup>2</sup> Hybrid is a type of plan that has a deemed account balance formula.

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question that within about a decade, those systems will be running short of money. So we should focus on issues like risk management, risk prevention and mitigation. If people will simply work a few more years, save a bit more and invest better, they're likely to be a lot happier 30 or 40 years from now."

"Today's boomers want to make their own, informed financial decisions," says Degnan. "With all of the information and options out there, boomers will look to work with financial professionals who provide them with the education they want, as well as objective insight, tools and advisory services that address their financial and lifestyle retirement needs — options that will give them certainty in their retirement — regardless of what happens to traditional forms of retirement income."

For more information on the Pension Protection Act, contact your AXA Advisors Financial Professional, who has received a Wharton Certificate in Retirement Planning, to discuss your retirement planning needs and refer to the following resources.

<http://www.dol.gov/EBSA/pensionreform.html>

<http://www.whitehouse.gov/news/releases/2006/08/20060817-1.html>

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1290 Avenue of the Americas, New York, NY 10104