Phased Retirement Programs: Has the World Changed?

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F. Scott Fitzgerald, the novelist who coined the expression the “Jazz Age” to describe the 1920’s, once said “There are no second acts in American lives.” Although the “Great Gatsby” did not make it to retirement, millions of Americans are disproving this maxim by varying their approach to traditional retirement in what is commonly known as “phased retirement.” It’s clear the world has changed greatly since the 1920’s and there has been much discussion in recent years about the importance of phased retirement as evidenced by growing numbers of employees leaving the labor force in other than traditional ways.

An important development in this evolution is the recently enacted Pension Protection Act of 2006 which now allows defined benefit plans to make payments to active employees beyond the age of 62 with distributions permitted in plan years beginning on or after January 1, 2007.

Previously, the inability to make such distributions before an employee either terminated employment or reached the plan’s normal retirement age had been one of the barriers to formal employer supported phased retirement. Now, with this new legislation, will we see major change with a great number of employers suddenly embracing phased retirement programs? In this article, we will share our opinions and hope that you will write in and share yours as well.

To address this question, it is first helpful to think about the decision process for launching a phased retirement program along with the program’s goals, benefits, and potential hurdles. In addition, to provide a full perspective when contemplating these programs, it is beneficial to examine how these programs have evolved in recent years.

What are the initial considerations for planning?

Our view is that the optimum way to plan for phased retirement is to first consider what options should be offered, to whom they should be offered, and how those who choose them should be paid. For example, some employees may simply want to continue in their same job with a reduced schedule. In this situation, pro-rata payment may be fair and reasonable compensation, provided that their health insurance is continued and they keep earning pension credits and/or receive a partial pension payment. For employees who will be used for special projects, as opposed to working a regular, although reduced schedule, the best option may be to let them formally retire and collect their pensions. The employer can then pay them for the project work, although it may want to limit project work to no more than 1,000 hours per year. In all of these situations, the guiding principle should be that the pattern of compensation to the employee should bear some relationship to the pattern of the work.

<u>What needs to be contemplated from a legal and compliance perspective?</u>
Prior to the Pension Protection Act, there were a number of legal issues involved in establishing a phased retirement program including compliance with the Age Discrimination in Employment Act, general non-discrimination rules, rules affecting the rehiring of retirees, the ability to make in-service distributions from a defined benefit plan and a host of other issues. The Pension Protection Act addressed only the in-service distribution issue so many other complexities and compliance issues surrounding phased retirement remain unchanged. In addition, final regulations incorporating the Pension Protection Act still need to be drafted and the ultimate language could alter an employer's optimum approach.

<u>How large should the program be?</u>

When thinking about the size of the program, it is important to assess current and future organizational resource needs and how the group of employees nearing retirement link to these needs. Some pertinent questions include:

- What talent gaps is the employer likely to have and for how long? Do they relate to numbers of full-time equivalents (FTE's) or firm-specific knowledge? Examples of firm-specific knowledge include relationships fostered with key customers, product expertise, institutional history, customized computer systems, etc.

- How many employees are likely to be eligible for such a program?

- Are there individuals associated publicly with the employer's brand? For example, a chief economist in a bank may provide a great deal of market prestige.

- Are there any groups of employees with highly specialized knowledge who are difficult to replace, e.g. research scientists in a pharmaceutical company, emergency room nurses in a hospital, nuclear engineers, etc.?

- Are there critical strategic business initiatives that would suffer without certain employees continuing their involvement because of retirement?

- At what age/length of service does the employer want to start offering phasing?

- How long would an employer need such a program in the qualified defined benefit plan and is it possible to eliminate it once it is there?

- How extensive should eligibility for the program be - only selected individuals, certain classes of employees or all employees?

For many larger companies it could require a significant research effort to address these and other related questions. In addition, the ultimate impact of the Pension Protection Act may be minimal or nonexistent for employers that want to be either selective with their programs or offer them to employees before age 62. In this sense, the world will have not have changed for those employers. Furthermore, for many other employers, more pressing strategic issues may need to take priority before meaningful progress on a phased retirement program can be accomplished.

How should the program be structured?

Once the employer has completed an initial evaluation of those individuals who might be eligible for the program and whether the program will be all-inclusive or selective, the employer's next step is to think about the structure of the available options. Some structural-related questions include:

- How can the potentially competing goals of how an employee adds value to the organization and what the employee wants from a phased retirement program be reconciled? (The key to success is finding the area that represents what the employee wants to do and what is valuable to the company.)

- When is the ideal timing for phasing to begin -- before the start of what was previously considered traditional retirement; or, after traditional retirement (i.e., rehiring retirees); or both time periods?

- What will be the extent of job restructuring, if any? How will pre-phasing duties, work schedule, and location be impacted?

- What work arrangements would be necessary to retain these employees or to attract these employees if the employer is seeking to hire another firm's retirees? Would it be regular part-time work throughout the year, full time seasonal-only work, or some other flexible work arrangement?

- Would the phasing program necessarily require mentoring, transfer of intellectual capital, transitioning external relationships with customers and others, and/or developing successors in specific roles?

- Is employee feedback such that the preference is for extensive phasing or minimal phasing or a combination of both? Do options need to accommodate a variety of work schedules?

To date, the marketplace has seen more activity in the rehiring of retirees, rather than phasing beginning before the start of traditional retirement. However, if the general election of part-time work options were counted, then it is unclear where there has been more activity. As we think about the impact of the new law, if we are focused on options for the rehire of retirees, there is no impact.

<u>What adjustments to compensation and benefits are needed?</u>

To ensure the program will operate smoothly, adjustments to compensation schedules and benefit plans may be needed. Key questions to be considered include:

- For phasing before retirement, will pro-rata pay or pay at the same rate be acceptable for both employer and employee? If not and the employer wants to encourage phased retirement, is the employer willing to compensate at higher levels to encourage participation in the phased retirement program? Further, are there non-monetary incentives that can be used? For rehire of retirees, what will be acceptable?

- Will phased retirees be in the active or the retiree health plan, or neither? How would health benefit plan eligibility provisions (such as minimum number of hours worked per week, etc.) be impacted?

- Would coordination with Medicare be affected? (Note that Medicare is secondary for individuals in the active employee health plan.)

- Would the program conflict with any employer policies for the provision of retiree health benefits? (The program would not work if the retirees lose their health benefits.)

Other decisions relate to an employer's pension plans. For final average pay plans, plan design must address :

- The method of crediting continuing service and compensation for partially retired employees.
- The amount of benefit paid during partial retirement and its form (lump sum versus a stream of payments).
- The procedure for reconciling expected and actual work schedules, including resulting benefit adjustments, if any.
- The frequency and methodology for recalculation of benefits.
- The time limit, if any, for partial payments.

A great deal of thought and detailed analysis will be needed to define the options linked to cash pay and benefits that support the employer's objectives. Here the world has changed and the new law enables new options. Employers sponsoring defined benefit plans have new options with regard to people age 62 and over. We do not know yet what will be in regulations, and that may make these options more or less attractive. The world has changed for companies that want to offer general programs for phasing into retirement and can live with age 62. That may not be a very large number of companies however.

How does an employer ensure a smooth program launch after the pieces have been put together?

In order for the program to work well, it needs to be positively supported by all levels of management and meld with the corporate culture. Managers need clear guidelines on the rules that apply and extent of independence they have when striking deals with their direct reports as well as their limitations. Further, there needs to be a well-documented process for instances when the human resources department needs to be involved in any negotiations. If the process that is implemented generates noncompliance and/or excessive employee complaints because of unclear policy rules, it can prove detrimental to effective implementation and acceptance of the program. Therefore, it is crucial to have properly communicated the ground rules of the program and decision-making procedure well before the launch of the program.

Has the Society of Actuaries done any work on this?

A focus of the Society of Actuaries 2005 Risk and Process of Retirement Survey was on how retirement is changing and the alternative paths many retirees are taking as they leave their primary careers. A report highlighting key findings from the survey as well as commentary on their relationship to other sources can be found at www.soa.org.

Will there be a deluge of phased retirement programs? The bottom line

While it is too early to tell how significant the Pension Protection Act will be as a significant motivator for more phased retirement, it is clear that there will not be a major increase in programs in the short run. Changes will depend on employers' evaluations of the questions outlined in this article. Furthermore, since the Act addresses only a relatively narrow aspect of phased retirement programs, it seems unlikely that it alone can be the catalyst for many additional programs. However as more employers are affected by the aging of America and if further enabling legislation were passed, we may see the beginning of a new era --- an era that, if F.Scott Fitzgerald were here today, he might have called, the "Phased (Phazzed?) Age."

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