

Part III

Defined-Benefit Pension Plans

According to the Employee Benefit Research Institute, company pension plans make up 19 percent of the typical retiree's annual income. For some retirees, the company pension is even the primary form of income. But not all pension plans are the same, and not everyone qualifies for one.

There are two basic types of company pension plans:

- the defined-**benefit** pension plan
- the defined-**contribution** pension plan

The ***defined-benefit plan*** is what many people think of when they hear the word “pension.” With these plans, the employer—or perhaps a union—guarantees a certain amount of money to the former employee each year during his or her retirement. A ***defined-benefit plan*** generally favors older workers, since they have a shorter time period in which to accumulate retirement funds.

The ***defined-contribution plan*** leaves much more responsibility in the hands of the employee, who must decide where and how much to invest. Rather than guarantee a specific annual payout during each year of retirement, the eventual benefits from a defined-contribution plan are based largely on the amount that the employee has invested and the success of the investments that he or she has selected. A ***defined-contribution plan*** usually favors younger employees that have a longer time period in which to accumulate retirement savings. The best-known ***defined-contribution plans*** are called 401(k) plans.

Given the choice, many employees would probably just as soon take the defined-benefit plan and leave more of the responsibility for their retirement to someone else. The defined-contribution plan has grown in popularity with employers ever since the introduction of the 401(k) in the early 1980s. Firms have discovered that defined-contributions plans are significantly cheaper for them to administer than defined-benefit plans—40 percent cheaper, by some estimates.

In this chapter we will take a closer look at the defined-benefit pensions.

Basics of Defined-Benefit Pensions

Millions of American workers and retirees can rest assured that they have a guaranteed pension for life even if their employer goes out of business or their pension plan runs out of assets. They are covered by defined benefit pension plans that are insured by the Pension Benefit Guaranty Corporation (PBGC), a federal agency.

Defined benefit pension plans are traditional plans that promise workers a specific monthly benefit at retirement. The amount of the benefit is known in advance, usually based on factors such as:

- age
- earnings
- years of service

The plan may state this promised benefit as a percentage of salary and years of service with the company as either:

- 1 percent of final pay times years of service
- a specific dollar amount and years of service – such as \$30 per month at retirement for every year a person has worked for the company
- or as an exact dollar amount – such as \$500 per month at retirement

In order to be able to pay the benefits that workers are earning, employers are required to make contributions to the plans. These contributions are supplemented by gains through the investment of the plan assets. The employer bears the investment risk and normally the plan investments are made by professional money managers.

Defined benefit pension plans offer both workers and employers a number of distinct advantages. The advantages for workers are:

- Workers can know in advance what their retirement benefit will be
- Employers, not workers, are responsible for providing retirement benefits, and the benefits are not dependent upon the amount of salary workers are willing or able to contribute nor are they subject to the fluctuations of the stock or bond markets
- A worker can earn a reasonable retirement benefit under a defined benefit plan, even if the worker has not been covered by a retirement plan earlier in a career
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- A retired worker receives a pension annuity, such as a monthly benefit, for life as does the workers surviving spouse, unless both the worker and spouse elect otherwise

Defined benefit plans can provide additional valuable benefits to workers, such as early retirement benefits, extra spousal benefits, disability benefits, benefits for past service, increased benefits, or cost of living adjustments.

PBGC guarantees to pay most - and often all - of the workers earned benefit if the employer cannot afford to pay the benefits or goes out of business. Advantages for the employer are:

- By providing a predictable, guaranteed benefit at retirement that is valued by workers, a defined benefit plan can promote worker loyalty and help retain valuable workers
- An employer can provide a significant retirement benefit for workers, even older workers for whom no contributions have previously been made, or who did not or could not save for retirement earlier.
- Defined benefit plans are flexible and can provide additional valuable benefits to workers
- An employer can design a defined benefit plan to accomplish corporate workplace goals, such as offering enhanced early retirement benefits
- Defined benefit plan assets are collectively invested, which usually results in higher investment returns
- While the employer bears the investment risks for the plan, favorable interest rates and economic conditions can reduce or eliminate an employers contribution, or make it possible to increase worker benefits at reduced or nominal cost.

Employees do not have much say in the investment decisions made by this type of pension plan, but that does not mean that they are free to take their pensions for granted. Even with the relatively user-friendly defined-benefit pensions, employees can make some mistakes that could jeopardize their retirement. The biggest error is to believe that a pension alone will be enough to pay for retirement. Few pensions replace more than 60 percent of the income that one is earning at the end of his career—and most replace less than half.

The Employee Retirement Income Security Act of 1974 (ERISA) established some relatively firm guidelines for the operation of corporate pension plans and also helped insure pension benefits. Public sector employees and some church employees might find that their pensions are not covered by ERISA rules, but the vast majority of private-sector pensions are covered.

The pensions of workers covered by private defined benefit pension plans are insured by PBGC. If the employer has financial difficulties and cannot fund the pension plan, PBGC takes over the plan and begins to pay benefits to workers already retired and to others when they retire. PBGC guarantees basic pension benefits. PBGC does not guarantee such benefits as health care, vacation pay, severance pay, or other benefits that are not considered basic pension benefits. While there are legal limits to the amount PBGC pays, the majority of workers still receive their full benefit. Today, there are more than 44,000 private-sector defined benefit plans insured by PBGC. There has been a decrease primarily among plans with 100 or fewer participants, while the number of large plans insured by PBGC - those with 1,000 participants or more - has remained relatively stable. These large plans are responsible for the steady rise in the number of workers and retirees covered by PBGC pension insurance, going from about 38 million in 1985 to 42 million today.

About one-half of the workers in the private sector are not covered by a pension. Many of these workers are employed by small businesses and are lower wage earners who are less likely to be able to save for retirement. The Administration and the Congress have proposed legislation that is aimed at expanding pension coverage, including a simplified defined benefit plan, insured by PBGC, for workers employed by small businesses.

Mechanics of Defined-Benefit Pension Plans

The employee receives a benefit statement and plan description each year. The exact pension formula varies from company to company, but usually the size of the eventual pension benefit is based primarily on three factors:

- The number of years the employee spends with the company
- The employee's average earnings over his tenure, or his peak earnings with the firm, or some combination of these two factors
- The age of the employee when he starts receiving his pension benefits

Not all pension plans calculate benefits exactly in this manner. One plan might use the average salary for the entire career, rather than just the final three or five years. It might use a different multiplier. Some plans even disregard earnings altogether and simply multiply a preset dollar amount by the number of years the employee was with the firm. Virtually all pension plans have additional rules and requirements that can affect the eventual size of the pension benefits that one receives, even if his basic pension is calculated along these lines.

Vesting

Most plan rules feature a “vesting” period. A vesting period is the number of years that one must spend with their employer before becoming “fully vested” with the plan – that is, the period after which he or she is fully entitled to receive all of the benefits that have built up in their account. If one leaves the company too soon, he or she might not be entitled to anything at all. Vesting is a way for companies to encourage their employees to stay with the firm. Under the Tax Reform Act of 1986, vesting formulas are likely to take one of two forms:

- **Cliff vesting** – with this vesting schedule, employees become fully vested after five years with the firm. This arrangement also is known as all-at-once vesting. With such a plan, if one leaves the company after four years and 11 months, they will probably receive no pension at all. If he or she stays one month more, they will receive 100 percent of whatever benefit has accumulated.
- **Graded vesting** - under a graded vesting plan, the plan participant typically will become 20 percent vested after three years in the plan, 40 percent after four years, and so on until full vesting is reached after year seven. This also is known as gradual vesting.

A defined benefit plan provides a promised plan benefit, based on a formula provided in the plan. For example, a defined benefit plan might provide an annual benefit of 50% of the final average earnings payable as a life annuity commencing at age 65. Defined benefit plans must be funded by the employer to pay the promised benefit, regardless of interest rate performance or other actuarial assumptions.

A defined benefit pension plan provides annual income, payable monthly, during retirement in an amount calculated by a formula contained in the plan. Current contributions are determined by an actuary based on the benefit defined in the plan and such variables as

- compensation,
- investment performance,
- years until retirement and
- life expectancy after retirement

Contributions must meet minimum funding standards and are mandatory. The plan can be designed to provide a maximum annual benefit at retirement of up to the lesser of the

highest consecutive three-year average compensation, or \$ 130,000 (currently, subject to cost of living increases).

Advantages and Disadvantages

The main advantage of a Defined Benefit Pension Plan is that contribution levels can be substantially higher for a participant who is close to retirement - 20 years or less. For example, a participant having a \$ 120,000 three-year compensation average (minimum compensation necessary to generate the defined contribution maximum contribution of \$ 30,000) with a plan formula specifying a benefit of 100% of compensation (highest 3 consecutive years average) beginning at age 65 could result in the following contributions dependent on the participant's age: age 55, \$ 89,500; age 50, \$ 49,200; age 45, \$30,142.

The main disadvantage is that certain actuarial assumptions are used to determine the plan's funding, and the plan's actual experience may differ from the assumptions and affect the level of future contributions. Due to the actuarial fees, a Defined Benefit Plan is more expensive to administrate than a Defined Contribution Plan.

Tax Savings

Every dollar contributed to one's Retirement Plan is a deduction on his tax return. A \$ 30,000 contribution will result in nearly \$ 12,000 of federal income tax savings at the top rate. There is no current taxation of Retirement Plan earnings. One pays taxes only when he or she takes distributions from the Plan that are not rolled over into an IRA or another qualified Plan. Taxes are only due on the amounts distributed and are generally taxed at one's normal tax rate for the year of distribution.

As an example: If during a calendar year one took a \$ 120,000 distribution from his Plan that had accumulated \$ 2,000,000, he would only pay taxes on the \$ 120,000 distributed. The earnings in the Plan that year would still not be subject to current taxation.

Cost-of-Living Adjustments (COLAs)

Most defined-benefit pensions are not as generous as they may at first appear because of the factor of inflation. Only a small number of defined-benefit pensions have any inflation adjustment built in. Three things that one should consider to prepare for the consequences of this factor:

- Do not assume that a defined-benefit pension will replace 50% of income

Part Three -- Defined-Benefit Pension Plans

- Leave the bulk of one's private retirement savings untouched for the early years of retirement
- Put a portion of the pension benefit that one receives during the early retirement years into savings; so that it will be there when the real value of one's future pension payments decline

Today, defined-benefit plans are offered primarily by large companies. These plans are expected to become even less common in the future. Pension benefits are relatively safe. Even if one's company goes out of business or its pension fund runs short of cash, the benefits payments are probably guaranteed by PBGC. Over the past 25 years, the PBGC has taken over the administration of more than 2,500 troubled pension plans providing benefits to nearly half a million workers.