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Objectives of a Retirement Program

In designing a retirement program, one of the first steps is to set forth the objectives the program is to satisfy. In the past, the answer would have typically included three major objectives. The first objective would be to provide the means by which older employees could be phased out of the work force with dignity. The second objective would be to provide a level of retirement income that would allow retirees to maintain their standard of living. The third objective would be to aid in the recruiting of new employees.

However, many experts are predicting a shortage of skilled workers in the next century. As a result, these objectives may have to be changed to discourage early retirement and to attract retirees back into the work force. Some companies may decide to offer their more valuable employees a more flexible retirement arrangement where they could either work part time, or only when there is a significant need for their unique skills. In addition, the retirement income objectives need to be modified to recognize the trend toward dual wage earners in most families.

There are many changes in the characteristics of the work force predicted by these experts. The Hudson Institute, in its study on WorkForce 2000, suggests that by the year 2000: (1) the work force will grow more slowly than at any time since the 1930s; (2) the average age of the work force will rise while the pool of younger workers will shrink; (3) more women will enter the work force; and (4) minorities and immigrants will represent an increasing share of the work force. Thus, the types of plans that are developed must be responsive to these changes, and the retirement income objectives modified accordingly.

In arriving at the right retirement income objective, the plan sponsor must determine the percentage of pre-retirement disposable income needed, recognizing: (1) the amounts of income available to the retiree from Social Security as well as the employer's pension and capital accumulation plans; (2) the change in the amount of taxes paid by the employee once he retires, recognizing federal, state and local tax structures; and (3) the retiree's cost for expenditures such as housing, food, clothing and medical care.

Income replacement ratios are normally developed when designing

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retirement programs. They represent the various sources of retirement income divided by the employee's compensation at retirement. These replacement ratios are reviewed to determine what is considered an "adequate" level of retirement income. They are also compared to the values provided by the programs of competitor companies.

These projected income replacement ratios are provided in the United States from Social Security and employer plans. These replacement ratios are for an employee who retires at age sixty-five after completing thirty years of service with his employer. They assume that the employer provided both a defined benefit pension plan as well as a 401(k) savings plan. The employee is assumed to have contributed 4% of his wages each year to the 401(k) plan and to have received a 2% company match. The 401(k) account balance, which is assumed to grow at 9% interest, has been converted to a equivalent monthly annuity in this illustration.

Social Security provides benefits which represent approximately 47% at income levels of $15,000, decreasing to around 11% at the $90,000 income level. Private, defined benefit plans are typically designed to be integrated with Social Security. The Tax Reform Act of 1987 allows plans to provide proportionately larger benefits (higher income replacement ratios) to higher compensated employees, recognizing the fact that Social Security provides proportionately larger benefits to lower paid employees. However, the IRS does place restraints on the amount of "permitted disparity" that is allowed. In this example, the pension plan is assumed to provide a 31% income replacement at the $15,000 income level, increasing gradually to a 43% income replacement ratio at the $90,000 income level.

Finally, the 401(k) plan is assumed to provide a 30% income replacement ratio at all income levels. This ratio does not vary as incomes increase because I have assumed that the total contribution going into the plan is 6% per year, regardless of income level. Typically, employees at lower income levels would be expected to contribute at lower levels, and thus receive smaller benefits than employees at higher income levels. However, due to limitations placed on higher paid employees, the difference in these contribution rates is also restricted by the IRS.

Alternative Vehicles Available for Financing Benefits

Once a company has decided on the level of benefits it wants to provide, the next step is to look at alternative vehicles available for financing these benefits. The three major types of plans utilized by employers to meet the retirement needs of their employees are: (1) defined benefit pension plans; (2) defined contribution plans; and (3) retiree medical plans.

Which vehicle an employer chooses depends on the characteristics of its work force and its willingness to accept the financial risk associated with financing these programs. For example, younger employees tend to prefer a defined contribution plan to a pension plan since they can see each year how the value of their account grows. In addition, many of them do not expect to be with the same employer when they retire, and thus, do not have much appreciation for a pension or retiree medical plan.

Defined contribution plans can be broken down into four major categories: (1) money purchase pension plans; (2) profit sharing plans; (3) savings plans; and (4) Employee Stock Option Plans ("ESOPs").

A money purchase pension plan is where the amount contributed each year is a stated dollar amount or a stated percentage of pay, and does not depend on the profitability of the company. The amount of money allocated to a employee each year from a profit sharing plan is dependent on the accumulated profits of the company and the plan's allocation formula. Company contributions to a savings plan are normally dependent only on the contributions made by the participating employees. ESOPs are a form of a stock bonus plan designed to invest in primarily the employer's common stock and noncallable preferred stock convertible into common stock.

Defined benefit plans are where benefits are determined based on some combination of an employee's age, service and, in many cases, compensation. Typically the plans for union employees, where benefits are negotiated, are not dependent on the employee's compensation. However, the plans covering salaried employees are usually dependent on the employee's compensation. The big question with pay-related plans is whether to base the benefits on the final average compensation over a period such as five years, or whether to use the average of the employee's compensation over his entire career.

Fixed dollar plans give the company the most control over plan costs since there is no commitment to have benefits keep pace with inflation in compensation levels. These plans are also easier to administer since compensation histories do not have to be maintained. However, because plan sponsors are not allowed to anticipate future inflation in benefit levels in determining their annual contributions, these plans typically have unfunded liabilities. Because of the lack of commitment to keep pace with inflation in wage levels, employees would typically prefer final average pay or career pay plans.

While final average pay plans are appreciated most by employees and rarely have problems with unfunded liabilities, they provide the least control over plan costs. Career average plans appear to be somewhere in between on most of the issues, except plan administration, where they require more information to be maintained than the other two types.

Special combination plans have been developed over the years to try to take advantage of both defined contribution plans and defined benefit plans. Floor plans are defined benefit plans which are offset by the value of benefits provided by a defined contribution plan. Thus, a floor plan is designed to provide a minimum level of benefit to the employee in the event the objectives of the defined contribution plan are not obtained.

Target benefit plans are defined contribution plans where the contribution is the annual amount required to fund the defined benefit based upon some set of reasonable assumptions. The employee under this arrangement would bear the investment risk. If the actual plan's investment earnings do not match the assumptions, the employee will either receive benefits that are greater than or less than the target level.

Cash balance plans are defined benefit plans that are communicated to employees as if they were defined contribution plans. They provide benefits in the form of lump sums, and the employee is advised each year as to how his "account" is growing. They have an advantage to employers who have an overfunded pension plan, because they can allocate amounts to individual employee accounts without making any additional contribution.

Retiree medical plans are another way to help retirees meet their retirement income needs. While defined benefit and defined contribution plans are designed to provide retirees the income necessary to cover their expenses, retiree medical plans are designed to help share the cost of medical bills more directly. There are various ways that plans are designed to share the cost with the retiree. Through the use of deductibles, coinsurance and limits on benefits, the company can control the extent to which benefits are provided by the plan. The medical costs not covered by the plan are therefore borne by the employee and medicare.

There can be further sharing by having the retiree pay for part of the cost or premium of the benefits covered by the plan. The plan can state that the retiree is to pay a certain percentage of the annual cost, such as twenty-five percent, by requiring retiree contributions.

The use of the "defined dollar benefit" approach has gained much attention in recent years. Under this approach, the company states the level of its commitment in terms of a defined dollar contribution it will pay each year. The employee must finance the remainder. Typically, the employer contribution is a stated dollar amount per year of service. The dollar amount may be automatically indexed to reflect inflation in medical costs and decreases at age sixty-five when the retiree becomes eligible for medicare.

General Factors That Influence a Company's Decision

The level of benefits provided, as well as the funding vehicle, is heavily influenced by factors such as: (1) competitive pressures in recruiting the work force; (2) cost of the program; (3) the company's business objectives; and (4) characteristics of the work force. It would be very difficult for a company to compete for top talent if it did not offer any retiree benefits at all while other companies in its industry offered these taxfavored benefit programs. However, the program selected has to be affordable and consistent with its business objectives.

If the company predicted that it will be one of the companies that will find it difficult to recruit sufficient numbers of skilled workers in the future, it probably should encourage flexible retirement programs and discourage early retirement incentives. For example, a defined contribution plan may be more attractive to someone who works beyond age sixty-five than a defined benefit plan.

SPECIFIC FACTORS THAT INFLUENCE PLAN DESIGN IN THE UNITED STATES

FASB's accounting standards, relative to the determination of the annual expense charge that must be recorded in determining the company's profit and loss statement, has had a big impact on not only the type of defined benefit plan companies want, but also whether it would be better off with a defined contribution plan instead. Similarly, the exposure draft on the accounting for retiree medical benefits is waking companies up to the substantial commitment they have assumed, and forcing them to re-evaluate these commitments. In addition, the impact of placing unfunded liabilities on a company's balance sheet has had a significant impact on plan design.

Not to be outdone by the FASB, the IRS has minimum requirements as to the timing and amount of contributions to fund defined benefit plans. However, it does not offer much opportunity to significantly fund retiree medical benefits. Without funding, the FASB cost for retiree medical benefits will grow in the future. While the IRS has limits on the extent to which contributions to a defined benefit plan can be deducted, the Tax Reform Act has increased the amount that a company can contribute if the plan is poorly funded. Unfortunately, it has also increased the required contributions for these poorly funded plans.

Defined benefits plans also have the PBGC to contend with. Currently the PBGC charges a basic premium equal to $16 per year, per participant. There is an additional variable premium that is based on the funded status of the plan which can increase the total premium to $50 per participant. Since employees who have not incurred a one-year break in service must be included in the head count, this becomes an extra burden for companies in high turnover industries.

The IRS has also placed limits on the amount of benefits and contributions that can be provided under qualified plans. Section 415 limits defined benefits amounts to $102,582 for retirement at age sixty-five for 1990. This amount is substantially reduced at earlier ages. It also limits contributions to a defined contribution plan to $30,000 and places additional combined limits on employees who are covered by both types of plans.

In addition, there is now a limit on the amount of compensation that can be recognized by qualified plans ($209,200 for 1990) and a limit on 401(k) salary deferrals ($7,979 for 1990). As if this were not enough, there is an excise tax on excess distributions. To insure that qualified plans do not discriminate in favor of highly compensated employees, companies must contend with: (1) Social Security integration rules; (2) ADP/ACP tests; (3) coverage rules; and (4) the definition of "highly paid" employee.

There are other factors which limit the flexibility a company has relative to its benefit plans such as: (1) minimum distribution rules starting at age seventy-and-one-half; (2) limits on recovery of pension surplus; and (3) restrictions on transferring assets from pension plans to retiree medical plans.

Hopefully, this trend toward increasing restrictions on qualified plans will end, but I would not count on it.