PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

CLASS NOTES

Chapter 22 Retirement Plans -Employee Benefits

Topics

- Fundamentals of Private Retirement Plans
- Defined-Benefit Plans
- Defined-Contribution Plans
- Profit-sharing Plans
- Keogh Plans for the Self-Employed
- Simplified Employee Pension
- Simple Retirement Plans
- Funding Agency and Funding Instruments
- Problems and Issues in Tax-deferred Retirement Plans

Fundamentals of Private Retirement Plans

- Private retirement plans have an enormous social and economic impact
  - The Employee Retirement Income Security Act of 1974 (ERISA) established minimum standards
  - The Pension Protection Act of 2006 increases the funding obligation of employers
  - Employers' contributions are deductible, to certain limits
  - Investment earnings on the plan assets accumulate on a tax-deferred basis
  - Private plans that meet certain requirements are called qualified plans and receive favorable income tax treatment
- A qualified plan must benefit workers in general and not only highly compensated employees
- Certain minimum coverage requirements must be satisfied
  - Under the ratio-percentage test, the percentage of non-highly compensated employees covered under the plan must be at least 70% of the percentage of highly compensated employees who are covered
  - Under the average benefits test, the average benefit for non-highly compensated employees must be at least 70% of the average benefit provided to all highly compensated employees

Fundamentals of Private Retirement Plans

- Most plans have a minimum age and service requirement that must be met
  - All eligible employees who have attained age 21 and have completed one year of service must be allowed to participate in the plan
  - Normal retirement age is the age that a worker can retire and receive a full, unreduced pension benefit (usually 65 years)

  - An early retirement age is the earliest age that workers can retire and receive a retirement benefit
  - The deferred retirement age is any age beyond the normal retirement age
- Vesting refers to the employee's right to the employer's contributions or benefits attributable to the contributions if employment terminates prior to retirement
- A qualified defined-benefit plan must meet a minimum vesting standard
  - Under cliff vesting, the worker must be 100% vested after 5 years of service
  - Under graded vesting, the worker must be 20% vested by the 3rd year of service, and the minimum vesting increases another 20% for each year until the worker is 100% vested at year 7
- Faster vesting is required for qualified defined-contribution plans to encourage greater employee participation
  - Employer contributions must be 100% vested after 3 years
  - The worker must be 20% vested by the 2rd year of service, and the minimum vesting increases another 20% for each year until the worker is 100% vested at year 6
- Funds withdrawn from a qualified plan before age 59½ are subject to a 10% early distribution penalty
  - There are some exceptions to this rule, for example if the distribution is made because the employee has a qualifying disability
- Pension contributions cannot remain in the plan indefinitely
  - Distributions must start no later than April 1st of the calendar year following the year in which the individual attains age 70½
  - This rule does not apply to certain IRAs
- Many qualified private pension plans are integrated with Social Security
  - Integration provides a method for increasing pension benefits for highly compensated employees without increasing the cost of providing benefits to lower-paid employees
  - Employers must follow complex integration rules, such as the excess method.

Fundamentals of Private Retirement Plans

- A top-heavy plan is a retirement plan in which more than 60% of the plan assets are in accounts attributed to key employees
  - To retain its qualified status, a special rapid vesting schedule must be used for nonkey employees
  - Certain minimum benefits or contributions must be provided for nonkey employees

Types of Qualified Retirement Plans

- A wide variety of qualified plans are available today to meet the specific needs of employers
- The two basic types of plans are
  - Defined-benefit plans
  - Defined-contribution plans
- Different rules apply to each type of plan

Defined-Benefit Plans

- In a defined-benefit plan, the retirement benefit is known, but the contributions will vary depending on the amount needed to fund the desired benefit
  - The amount can be based on career-average earnings or on a final average pay, which generally is an average of the last 3-5 years earnings
  - A firm may give an employee past-service credits for prior service
- Retirement benefits in defined-benefit plans are based on formulas
  - Under a unit-benefit formula, both earnings and years of service are considered
  - Some plans pay a flat percentage of annual earnings, while some pay a flat amount for each year of service
  - Some plans pay a flat amount for each employee, regardless of earnings or years of service
- The Pension Benefit Guaranty Corporation (PBGC) is a federal corporation that guarantees the payment of vested benefits to certain limits if a private pension plan is terminated
  - For plans terminated in 2012, the maximum guaranteed pension at age 65 is $4653.41 per month
- Many traditional defined benefits plans are substantially underfunded at the present time
- A cash-balance plan is a defined-benefit plan in which the benefits are defined in terms of a hypothetical account balance
  - Actual retirement benefits will depend on the value of the participant's account at retirement
  - Each year, participant's accounts are credited with a pay credit and an interest credit
  - The employer bears the investment risks and realizes any investment gains
  - Many employers have converted traditional defined-benefit plans into cash-balance plans to hold down pension costs

Defined-Contribution Plans

- In a defined-contribution plan, the contribution rate is fixed but the actual retirement benefit is variable
  - For example, a money purchase plan is an arrangement in which each participant has an individual account, and the employer's contribution is a fixed percentage of the participant's compensation

Defined-Contribution Plans

- Most newly installed qualified retirement plans are defined-contribution plans
  - Cost to employer is lower because they do not grant past-service credits
- Disadvantages to the employee include:
  - Employees can only estimate their retirement benefits

  - Investment losses are borne by the employee
  - Some employees do not understand the factors to consider in choosing investments

Profit-Sharing Plans

- A profit-sharing plan is a defined-contribution plan in which the employer's contributions are typically based on the firm's profits
  - There is no requirement that the employer must actually earn a profit to contribute to the plan
  - Funds are distributed to the employees at retirement, death, disability, or termination of employment (only the vested portion), or after a fixed number of years
  - For 2012, the maximum employer tax-deductible contribution is limited to 25% of the employee's compensation or $50,000, whichever is less
  - There is a 10% tax penalty for early withdrawal

Keogh Plans for the Self-Employed

- Retirement plans for the owners of unincorporated business firms are commonly called Keogh plans
  - Contributions to the plan are income-tax deductible, up to certain limits
  - Investment income accumulates on a tax-deferred basis
  - Amounts deposited and investment earnings are not taxed until the funds are distributed
- A simplified employee pension (SEP) is a retirement plan in which the employer contributes to an IRA established for each eligible employee
  - Annual contribution limits are substantially higher
  - One type, called a SEP-IRA, must cover all workers who are at least age 21 and have worked for at least three of the past five years
  - There is full and immediate vesting of all employer contributions under the plan
  - Employees cannot contribute to the plan

SIMPLE Retirement Plans

- A Savings Incentive Match Plan for Employees (SIMPLE) plan is limited to employers that employ 100 or fewer employees and do not maintain another qualified plan
  - Smaller employers are exempt from most nondiscrimination and administrative rules that apply to qualified plans
  - Can be structured as an IRA or 401(k) plan
  - For 2012, eligible employees can elect to contribute up to 100% of compensation up to a maximum of $11,500
  - Employers can contribute in one of two ways: through a matching option or a nonelective contribution option

Funding Agency and Funding Instruments

- A funding agency is a financial institution that provides for the accumulation or administration of the funds that will be used to pay pension benefits

- A trust-fund plan is administered by a commercial bank or individual trustee
  - An insured plan is administered by a life insurer
  - A split-funded plan is administered by both
- A funding instrument is a trust agreement or insurance contract that states the terms under which the funding agency will accumulate, administer, and disburse the pension funds
- Under a trust-fund plan, all contributions are deposited with a trustee, who invests the funds according to the trust agreement
  - The trustee does not guarantee the adequacy of the fund, the principal itself, or interest rates
- A separate investment account is a group pension product with a life insurance company
  - The plan administrator can invest in one or more of the separate accounts offered by the insurer
  - Pension contributions can be invested in stock funds, bond funds, or similar investments
- A guaranteed investment contract (GIC) is an arrangement in which the insurer guarantees the interest rate for a number of years on a lump sum deposit
  - They are sometimes used to fund the fixed-income option in a defined-contribution retirement plan
  - Most GICs make annuity options available at retirement

Problems and Issues in Tax-deferred Retirement Plans

- Several serious problems exist among current tax-deferred retirement plans
  - Inadequate 401(k) account balances
  - Incomplete coverage of the labor force
  - Lower benefits for women
  - Limited protection against inflation
  - Workers spending lump-sum pension distributions
  - Investment mistakes by participants that jeopardize economic security

End.