



Defined Benefit and Contribution Plans in the United States Background

History

The first employer-sponsored retirement plan was established in 1875 by the American Express Company, then a successful freight delivery business taking part in the United State's westward expansion. That plan soon was followed by pensions by utilities, banking and manufacturing companies. Almost all the early plans were traditional pension, or defined benefit, plans. That is, employers funded the plans and workers were paid a specific monthly payment for life upon retirement.

In the early 20th century, several federal regulations assisted with the growth of defined benefit plans. The Revenue Acts of 1921 and 1926 allowed employers to deduct pension contributions from corporate income and income from pension fund portfolios to accumulate tax free. In the 1940s, pension plans were exempt from wartime wage controls leading many employers to channel large amounts of money into the plans. Then in 1948, the National Labor Relations Board declared that pensions "lie within the statutory scope of collective bargaining" and the growth of pensions took off. Union success in this area can be measured by the fact that between 1945 and 1960, pension coverage increased from 19 to 40 percent of the workforce.

Prior to 1974, there was little protection provided for workers covered by these plans. As a result, employees were subject to losing all or part of their retirement benefits should their company fail to adequately fund their plans, close or fall into bankruptcy. In 1963 when Studebaker closed its automobile plant in South Bend, Indiana, that's exactly what happened when thousands of employees lost some or all of their promised benefits.

In 1974, Congress acted by enacting the Employee Retirement Income Security Act (ERISA), which covers both traditional defined benefit plans and defined contribution plans. Under ERISA, the U.S. Department of Labor is responsible for seeing that pension plans are properly operated, and the Internal Revenue Service is responsible for pension plan funding, vesting requirements and ensuring compliance with tax laws.

ERISA also established the Pension Benefit Guaranty Corporation (PBGC) to insure certain defined benefit plans by guaranteeing benefits up to certain legal limits. If a plan ends without sufficient money to pay all benefits, PBGC's insurance program is available to pay benefits within limits established by law. PBGC receives no funds from general tax revenues. Instead, its operations are financed by insurance premiums set by Congress and paid by sponsors of defined benefit plans, investment income, assets from pension plans trusted by PBGC, and recoveries from the companies formerly responsible for plans.

The Shift to Defined Contribution Plans

In recent years, companies have begun moving away from defined benefit plans as the plans have become more expensive to fund and as retirees have begun to live longer. In their place has come a growth in defined contribution plans, typically 401(k)s, which place the responsibility and risk to adequately fund a retirement on employees. Reflecting this shift, in 2004 the PBGC insured about 30,000 single-employer defined benefit plans, compared to an all-time high of 112,000 plans in 1985.

With the passage of the Pension Protection Act of 2006 (PPA) and the stronger pension funding requirements it places upon employers, it is expected that even more businesses will move away from defined benefit plans and shift toward employee-funded defined contribution plans or cash-balance plans. The most significant reform legislation since the Economic Growth and Tax Relief Reconciliation Act of 2001, the PPA rules require companies that have underfunded their pensions to pay additional premiums, that companies measure the obligations of their pension plans more accurately, and that when the rules are fully implemented companies meet a pension funding target of 100 percent of liability.

Different from pensions, defined contribution plans require employees to assume responsibility for funding their own plan and deciding how much they wish to invest and in what funds. Often employers will provide a matching contribution based on the amount an employee chooses to save. But employees bear the risk for the performance of their investments, not the employer.

Under defined benefit plans, employees generally are not required to make contributions and are not responsible for investment decisions. Employers direct the investments and bear the risk, and benefits are paid out generally in the form of a lifetime annuity based on an employee's salary and years of service.

Cash-balance plans, in essence, are a hybrid plan. In a typical cash-balance plan, an employer contributes a set amount of money to an account each year and guarantees that the account will grow at a certain rate every year. When an employer converts from a traditional pension plan to a cash-balance plan, workers' benefits generally increase at a lower rate, meaning monthly retirement benefits, especially for longer-term workers are significantly reduced. The Government Accounting Office estimates that for a 50-year employee, the median reduction in monthly benefits is \$238. Unlike most pension plans, however, employees in a cash-balance plan can opt to take a lump sum distribution when they leave their employer, rather than waiting to receive a monthly payment once they retire.

In recent years, a number of major companies have announced they are freezing their pension plans, including Verizon, Lockheed Martin, Motorola and IBM. And more than a third of U.S. companies with a pension plan report that they also are considering freezing benefits. When a pension is frozen, the company stops the growth of its employees' retirement benefits, which normally increase with each additional year of service. Participants get to keep the benefits they have already earned, but their monthly payment upon retirement may be sharply reduced. Often when a pension is frozen, the company will replace it with either a cash-balance plan or a defined contribution plan, typically a 401(k).

In addition to the plans that are being frozen, several large companies also have terminated their pension programs as part of their bankruptcy, including US Airways and United Airlines. Forced to pick up the tab, the PBGC now has a record deficit of more than \$23 billion, as it also is faced with an estimated \$450 billion under funding of American pensions.

The Challenge for Americans

The trend is clear: Americans now need to assume responsibility for funding their retirement. Yet only 42 percent of Americans have calculated what they will need in retirement, with many believing they will need less than 70 percent of their existing income. Retirement experts, however, estimate that individuals will need 80 – 90 percent of their pre-retirement income to live comfortably.

For those who are participating in 401(k) plans, many also are contributing less to their plans than in years past. For example, the percentage of salary being put into 401(k) plans, known as the deferral rate, dropped from 8.6 percent in 1999 to 6.9 percent in 2005, a 20-percent decline.

Currently, three out of four eligible workers are offered defined contributions plans where they work with employers matching all or part of their contribution. Yet only one in 10 contribute the maximum amount allowed, and nearly half don't contribute enough to take full advantage of their company's matching funds. About half also cash out their 401(k) savings when they change jobs instead of rolling the money into an IRA, allowing them to avoid the tax implications and to continue investing for their retirement.

It is estimated that 51 percent of workers age 55 and up have saved less than \$50,000 for retirement, not counting the value of their primary residence. The Employee Benefits Retirement Institute 2005 Retirement Confidence Survey shows that Americans are failing to adequately save for retirement for several reasons: the cost of everyday expenses, child rearing expenses, medical expenses and debt. Six in 10 Americans report that their level of debt is a problem.

Helping Americans to Save for Retirement

With the average person spending 18 years in retirement, it is critical that more Americans start planning better and saving more. They need to be educated about the implications and encouraged to place more of a priority on retirement savings. One effective tool to encourage people to start saving, and to save more, is to conduct a retirement need assessment. Among those who have estimated their retirement needs, nearly half (44 percent) have made changes to better fund their retirement. Of that

number, 57 percent started to save more, 19 percent changed the allocation of their money, 13 percent researched other methods to save for retirement (e.g. new products, financial planners), 2 percent lowered their debt, and 1 percent started saving for the first time. To perform a retirement needs assessment, visit the AICPA's 360 Degrees of Financial Literacy Web site at www.360financialliteracy.org.