NRTA PENSION EDUCATION TOOLKIT

Frequently Asked Questions

What is a pension?

A traditional pension plan, also called a defined benefit (DB) pension plan, is a pooled retirement plan that offers a predictable, defined, monthly benefit in retirement. A DB pension provides retired workers with a steady income stream that is guaranteed for the remainder of the retiree's life.

How are benefits earned?

In a traditional DB pension plan, coverage is universal; all eligible employees are automatically enrolled in the pension plan. Typically, after an employee has worked a certain number of years, his or her right to receive a pension benefit becomes "vested," meaning that s/he has a legal right to receive benefits. Years of service before vesting are included in the calculation of the pension benefit in retirement.

The amount of monthly income each employee receives is ordinarily a function of the years of service with the employer, the worker's pay at the end of his/her career, and a fixed multiplier that is determined by the plan. Under this design, the plan may provide a benefit multiplier of, for example, 2.0% of pay. If an employee works for 30 years and has a final average salary of $40,000, this employee's annual pension income will be $24,000 (40,000 x 30 x 2.0%), which translates to a pension income of $2,000 per month.

How are pensions funded?

State and local DB pension plans are usually funded by employer contributions and contributions from employees themselves, while private sector pension plans are almost always funded solely by employer contributions.

All DB pensions have the advantage that investment earnings can do much of the work of paying for benefits, because the contributions made on behalf of current workers are invested, and these investment earnings compound over time.

Earnings on investments have historically made up the bulk of pension fund receipts. Between 1993 and 2011, 12% of total state and local pension fund receipts came from employee contributions, 25% from employer contributions, and 63% from investment earnings.

NRTA
AARP's Educator Community
NATIONAL INSTITUTE ON Retirement Security
Reliable Research. Sensible Solutions.

What are the effects of the economic downturn on pensions?

The historic stock market decline that began in 2008 has presented challenges for all investors, including pension plans. Yet the downturn has also highlighted how critical pensions remain in addressing the retirement security challenges for Americans. Indeed, Americans without pension income who must rely solely on their savings and Social Security face the biggest challenges.

Also, despite the market impact, most public pensions have sufficient assets on hand to pay benefits for many years, even decades. Even so, many plans have evaluated benefit levels and financing structures to ensure long-term sustainability, and states have already made significant pension reforms, including increased contribution rates, decreased multipliers, and increased age and service requirements. Boston College finds that for most states, these reforms already implemented should fully offset the effects of the economic downturn. Indeed, as the economy has begun to stabilize, plans are continuing to assess the path forward to ensure they can continue to provide a modest retirement benefit in fiscally responsible manner.

How are contribution rates determined?

The amount needed to contribute to the pension plan each year can be determined through an actuarial analysis. The plan actuary determines the cost associated with new benefits earned in that year (normal cost) plus any additional amount that might be required to make up for shortfalls that have developed in the past.

To ensure that the plan will have enough assets to pay future benefits, it is important that the annual required contribution (ARC) be contributed to the pension trust each year.

Is it important to fund the pension each year?

Yes. It is important that the actuarially required contribution (ARC) be contributed to the pension trust each year, for several reasons. First, if a plan does not fully fund the ARC every year, the plan is likely to become underfunded, which means that the plan's assets will not cover all of the plan's current and future liabilities. Postponing payments will only increase the ARC in future years, because the ARC will now consist of both the normal cost and a portion of the unpaid liabilities from past years, also called the unfunded actuarial accrued liability (UAAL).

Second, if progress is not made toward closing the plans' funding gap over time, the plan sponsor runs the risk of being seen as a greater credit risk; it can be given a lower credit rating, and when this happens, the cost of borrowing increases.

Finally, if a plan is chronically underfunded for a substantial period of time, it may actually run the risk of not having enough assets to pay out current liabilities—in other words, there may not be enough funds in the pension trust to cover payments that must be made to current retirees. In this scenario, the plan is no longer a pre-funded system and becomes a pay-as-you-go system, in which current payments are made out of the current revenues.

Public pension plans as a group have been diligent about pre-funding. Recent investment losses have presented challenges, but most plans are on the path to recovery, having already implemented many adjustments to contribution rates and benefit design.

How are investment decisions made?

DB pension plans are overseen by trustees who have a fiduciary duty to ensure that the retirement fund is operating in the best interest of workers and retirees. These trustees hire professional asset managers to steer the investment of these funds.

Both public and private sector pension plans should maintain a balanced portfolio of equities, bonds, alternative investments, and cash. In doing so, plans follow the general tenets of modern portfolio theory, which holds that an investor can reduce risk and enhance return by diversifying assets across the entire portfolio. In the aggregate, state and local pension plans' asset allocations are likely to look quite similar to those of pension plans in the private sector.

A plan's asset allocation at any one time is not permanent—plans regularly review their portfolio mix, and make revisions when appropriate. A recent study has found that DB pension plans tend to invest pragmatically, looking to the long-term and engaging in prudent investment practices.

What is the difference between a traditional pension and a 401(k)-type plan?

A traditional pension is also called a defined benefit (DB) plan, and a 401(k) is a type of individual retirement savings plan also called a defined contribution (DC) plan. The main difference between DB and DC plans is that DB plans are pooled retirement plans, and DC plans consist of individual accounts. Stemming from this, DB and DC plans differ in contributions, investments, money in retirement, payout in retirement, and supplemental benefits.

	Defined Benefit Plan (Traditional Pension)	**Defined Contribution Plan** (401(k)s, 403(b)s, 457s)
Contributions	In the public and private sectors, contributions are made on behalf of each employee by the employer. In the public sector, many pensions are "contributory," meaning that employees also contribute to the plan out of their own paychecks.	Employees make their own contributions to their savings account at whatever rate they choose. Often, employers will make a certain match—for example, 50 cents on the dollar up to 6% of pay—but they are not required to contribute at all.
Investments	Contributions for all employees are pooled, and invested by professional asset managers in a range of assets—stocks, bonds, real estate, etc.	Employees usually make all investment decisions themselves. They can choose from a range of investment options offered by the plan.

Amount of Money in Retirement	The monthly benefit is determined by a set calculation—usually based on years of service and pay at the end of one's career.	The money available in retirement is simply the amount that one has accumulated in the savings plan, through contributions and investment earnings.
Payout in Retirement	Payouts are typically provided as a monthly income stream that is guaranteed for the remainder of the retiree's life.	Plans are not required to offer a lifetime income payout. Payout is often a one-time, lump sum payment.
Supplemental Benefits	Spousal protections, disability benefits, and cost of living adjustments are common.	Supplemental benefits are not applicable.

Who has a pension?

Of the 35.4 million older American households in 2010, about 42% had income from a DB pension. Of older households with pension income, 13.7 million had pension income from a private sector job, 6.9 million had pension income from a public sector job, and 3.0 million households had both public and private sector pension income.

Among current U.S. workers with a DB pension plan, there are more private sector employees with pensions than public sector employees. In 2010, 17.9 million private-sector American workers had a workplace DB pension plan, while state and local pension plans served 14.6 million workers. In 2011, 78% of public sector employees had a DB pension, as compared with just 18% of private sector workers.

Who is most likely to have a pension?

In the private sector, those workers who are unionized, working for large firms, and/or full-time employees are in general more likely to have DB pension coverage than those who are nonunionized, working for small firms, and/or work part-time.

Among demographic groups, white men are still more likely to have DB pension income than women and members of racial and ethnic minority groups. However, when racial/ethnic minorities and women do have a pension, their pension income plays a unique role in shrinking gender and racial/ethnic income gaps in retirement.

How much pension income do people usually receive?

Although pension income goes a long way in ensuring that Americans have adequate income in their retirement, benefits tend to be relatively modest. Among Americans aged 60 and older receiving a pension from their own former employer, in 2010 the average pension benefit was $19,427 per year, and the median benefit was $14,400 per year.

Breaking out public and private sector pensions, the median amount of public pension income was $22,853, while the median amount of private pension income was $9,593. Pensions are a form of deferred compensation and many public employees work for less salary then their private sector counterparts knowing that their pensions give added value to their compensation. This difference may exist because public employees, unlike private sector workers, contribute to their pensions. Also, public sector workers tend to have longer job tenures than those in the private sector, which can lead to higher pension income. Finally, benefits may be greater to compensate for lack of Social Security coverage in the public sector.

What have been the pension trends over time?

Over the past several decades, traditional pension coverage has been on the decline in the private sector. In 1993, 35% of private sector workers were covered by a DB pension plan; by 2011, that number dropped to just 18%.

The public sector, by contrast, has been able to maintain DB coverage for the vast majority of its employees.

What is the current status of retirement security in america?

We have a retirement savings gap between what American households need to save for retirement and what they have saved that approaches $7 trillion based on household net wealth, including appreciated housing values. American workers are therefore right to be anxious about their retirement security. And only a mere 2% of Americans believe that it will be easier to prepare for retirement in the future.

Older low- to middle-income workers, in particular, are facing a daunting financial challenge. Indeed, 37 percent of the middle-income workers age 45–54 are projected to be downwardly mobile to lower income status in retirement, based on a study by the Urban Institute. All told, 9 out of ten workers fall short of target retirement savings benchmarks designed to allow older Americans to maintain their standard of living prior to reaching typical retirement ages.

One reason for this increase in retirement insecurity in America beyond the economic downturn is that 78 million American workers have no access to any retirement plan at work. Few of these individuals save for retirement on their own outside of the workplace, and many will retire with less than enough money to meet their basic needs.

The typical working-age household has only $3,000 saved in retirement accounts, while the typical near-retirement age working household has just $12,000 saved. To put this amount of retirement savings into context, even the near-retiree savings amount is less than the modest average annual Social Security benefit earned by retired Americans of $15,190.

Why do pensions matter to employees?

Retirement researchers have long acknowledged the importance of the so-called "three-legged" stool—of Social Security benefits, defined benefit (DB) pension income, and supplemental individual savings—in providing Americans the greatest opportunity to achieve financial security in retirement.

Specific characteristics of traditional DB pension plans make them very effective at supporting retirement security for American workers and their families. First and foremost, DB pensions provide lifetime income. Also, DB pensions are broad-based and professionally managed, making them more secure sources of retirement income. Finally, DB pension plans typically provide ancillary benefits such as COLAs, spousal protections and disability benefits.

DB pension income plays a substantial role in ensuring that Americans remain self-sufficient in retirement. Income from DB pensions helped 4.7 million older households avoid being below or close to the poverty line in 2010.

How greatly do workers value their pensions?

Employees value DB pension plans highly, and are more committed to employers who offer them. A 2012 study by Towers Watson shows that DB plans have much stronger recruitment and retention effects among employees than DC plans. A 2008 MetLife survey found that 72% of employees cite retirement benefits as an important factor in their loyalty to their employer.

How do pensions help women and minorities?

Women and racial and ethnic minority groups are more at risk in retirement than their white male counterparts for two reasons. First, they still make less money over their careers, and second, they have less access to workplace retirement plans.

Yet DB pension plans seem to play a unique role in shrinking these gender and racial/ethnic gaps in retirement. That is, the percentage of American households classified as poor and near poor drops across gender and race categories when older Americans have pension income.

Why do pensions matter to employers?

DB pension plans are extremely valuable to employers who have specific human resource goals for their workforces and are an important recruitment and retention tool across industries. Because of their deferred nature, retirement benefits encourage employees to stay with an employer. In a traditional, final pay-based pension plan, workers earn benefits more rapidly the longer they stay on the job; this leads to higher rates of retention. One study found that workers with pensions are 17% more likely than workers without pensions to stay at their jobs in a single year, all else equal. Another found that firms with pension coverage saw lower turnover rates than non-pension firms.

And less job turnover is likely to lead to more knowledgeable employees and less cost for employers to find, hire and train new employees. Among employers, a 2004 survey found that 84% of DB plan sponsors believe that their pension plan has a positive impact on employee retention. Additional research has found that DB pension plans reduce turnover by 13 percentage points, and quit rates by 20 percentage points, on average.

Why do pensions matter to taxpayers?

Especially when compared with other types of retirement benefits, pensions are an economically efficient and prudent use of taxpayer funds.

Are pensions more economically efficient than defined contribution plans?

Yes. A recent analysis of the cost to achieve a target retirement benefit under both a DB and DC structure found that a DB plan cost nearly half as much as the DC plan. That is, the cost to deliver the same retirement income to a group of employees is 46% lower in the DB plan than in the DC plan.

The reason for such cost savings is threefold. First, because DB plans pool the longevity risks of large numbers of individuals, they need only accumulate enough funds to provide benefits for the average life expectancy of the group. Second, DB plans are able to take advantage of the enhanced investment returns that come from a balanced portfolio over long periods of time. Third, DB plans, which have their funds invested by professional asset managers, pay lower fees and achieve greater investment returns than individuals investing their DC accounts.

Is it cheaper for state and local governments to switch from a DB pension to a DC plan?

Studies have found that adjusting the DB benefits is the most cost efficient way to reform pensions. Shifting to DC accounts for new hired would lead to greater costs to reach similar benefit levels. It would cost about 83% more to provide the same level of income in a DC plan than it would through a DB pension. If the switch to the DC plan wanted to lower the costs, benefits would be significantly reduced.

Also, establishing a DC plan or even a hybrid plan for new hires does nothing to reduce unfunded liabilities. This is evident based in the actual experience of the federal government closing the Civilian Retirement System and the State of West Virginia which closed and then reopened its Teachers' Retirement System as benefits were inadequate and funding levels remained low. The State of Utah, which enacted changes still requires public employers to contribute about 9% of salary of all employees towards reducing the unfunded liability.

Are there any other reasons why DBs might be a good deal for taxpayers?

Yes. DB pension plans also save governments money in reducing citizens' need to rely on public assistance. A recent study finds that DB pensions have been instrumental at keeping elder Americans out of poverty. In 2010 poverty rates among older households lacking pension income were about nine times greater than those with such income. Also, 460,000 fewer households experienced a food hardship, 500,000 fewer households experienced a shelter hardship, and 510,000 fewer households experienced a health care hardship, because they had income from a pension.

When fewer households experience poverty and financial hardship, federal, state, and local governments see a cost savings in terms of public assistance expenditures avoided. The report calculates a savings of some $7.9 billion in public assistance expenditures in 2010 attributable to receipt of pension income. This represents about 6.4% of aggregate public assistance dollars received by all American households in 2010.

How do pensions fit into the broader economy?

The economic impact of DB pensions reaches well beyond the retirees who receive pension checks. DB pensions play a vital role in the national economy as well as in local economies across the country, largely due to two different types of economic channels: the benefit channel, in which retirees' spend their benefits, thereby creating incomes for businesses and other workers in the economy, and the investment channel, in which the investment of pension assets provides capital to businesses. Each of these impacts is substantial.

What are the economic effects of retirees spending from their DB pension income?

It is important to note what happens when a retired worker receives their earned pension benefits. They typically spend it, and usually in the economy in which they live. As such, the businesses where this money is spent see a boost in profits, which may allow them to expand their business or even hire more workers, otherwise known as the "multiplier effect."

Expenditures made out of DB pension plans have a broad economic impact, both nationally and on the local level. In 2009, expenditures made out of pension payments supported more than 6.5 million American jobs that paid more than $315 billion in labor income. Pension expenditures also supported over $1 trillion in total economic output nationwide and over $134 billion in federal, state, and local tax revenue.

State and local pension expenditures also have large multiplier effects. For each dollar paid out in pension benefits, $2.37 in total economic output was supported. And for every dollar contributed by taxpayers to state and local pension funds, $8.72 in total output was supported.

What effects do pension investments have on capital markets?

Because DB pensions are prefunded, investment of pension assets provides capital to businesses to help develop products, invest in new technologies, and even create jobs.

DB pensions have longer time horizons than DC plans, and because of this they can achieve greater stability in asset allocations. This "patient capital" offers benefits for financial markets, since professional investors who follow a long-term strategy are less likely to cause market disruptions by chasing short-term returns.