NRTA PENSION EDUCATION TOOLKIT

Glossary of Terms

A

Annuity

A specified income payable at regular, stated intervals for a set period of time, often for the remainder of a recipient's life.

Annual required contribution (ARC)

The actuarially determined pension fund contribution in a single year. This includes the normal cost of the plan and also may include another amount that may be required to pay for a portion of benefits earned in past years that have not yet been funded.

Asset allocation*

Investment strategy that apportions a portfolio's assets according to the investor's goals, risk tolerance, and investment horizon. Allocation typically involves selecting assets representing different asset classes. The assets in each class have different levels of risk and return, and may behave differently over time.

B

Benefit multiplier

A fixed percentage that is typically used, in conjunction with an employee's final average salary and years of service, to determine an employee's pension benefits.

Benefit policy

Term used to describe the basis for which employees earn benefits in the plan.

C

Cash balance plan

A type of defined benefit pension in which participants' benefits are expressed as a notional account balance that is eventually translated into lifetime income payments. The benefits are not expressed as a percent of final salary, but rather based on a given percentage of each year's pay that earns a specified interest rate guaranteed by the employer.

Cost of living adjustment (COLA)

A change in one's monthly retirement benefit to account for increasing prices, or inflation. COLAs help to ensure that retirees' purchasing power remains the same no matter how long they may live, and how quickly prices might rise. COLAs can be prescribed—for example, a fixed 3% per year, or an amount tied to increases in the Consumer Price Index. COLAs can also be ad-hoc in nature, which means that they are granted at the discretion of the state each year.

D

Defined benefit (DB) plan*

Employee retirement plan established and maintained by an employer that uses a predetermined formula to calculate the amount of an employee's retirement benefit. Early DB plans (referred to as flat benefit plans) were commonly a set dollar amount that was the same for all employees, regardless of their actual compensation, or a fixed percentage of an employee's compensation. Any employee who worked for the company a minimum number of years received the same dollar amount or fixed percentage upon retirement. Today, DB plans and their formulas are more likely to take into consideration an employee's years of service; such plans are called unit benefit plans. Employer contributions to DB plans are determined actuarially. No individual accounts are maintained, as is done for defined contribution plans. In the United States, [federal law considers] any plan that is not an individual account plan a defined benefit pension plan.

Defined contribution (DC) plan*

As defined by [federal law], a plan that provides an individual retirement account for each participant with benefits based solely on (1) the amount contributed to the participant's account plus (2) any income, expenses, gains, losses and forfeitures from other participants. Contributions to an account may be made by the employee [and/]or the employer. Defined contribution plans include 401(k), 403(b) and 457 plans.

F

Fiduciary*

Person or institution legally responsible for the management, investment, and distribution of a fund. The trustees and administrators who are responsible for the oversight of employee benefit trust funds are considered fiduciaries. [Federal law] defines fiduciary as any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets; (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan or has the authority to do so; or (3) has any discretionary authority or responsibility in the administration of a plan.

Funding gap

The situation in which a pension plan's obligations (the total dollar value of the benefits that have been promised by the plan, and earned by employees and retirees) exceed the assets set aside to pay for them. Also called an "unfunded liability" or "unfunded actuarial accrued liability."

Funding policy*

Statement(s) clarifying the goals and objectives of a benefits plan, and how to achieve them. This policy should include the amounts and timing of contributions by employers and participants.

H

Hybrid plan

A retirement plan that has the characteristics of both a defined benefit (DB) pension plan and defined contribution savings plan. In general, the DB portion of a hybrid is far less generous than the previous traditional DB plan, and the savings portion with contributions to an individual DC account is meant to offset this reduced benefit in part.

I

Investment policy*

Commonly used to describe how contributions to an employee benefit plan are to be utilized from the time they are received until benefits are paid.

L

Liability

The total dollar value of all the pension benefits that have been promised by the pension plan, and earned by all current employees, terminated vested employees, and retirees.

N

Normal cost

The cost of the pension benefits earned in the current year.

P

Pay-as-you-go retirement system

A system in which current benefits are paid out of the current year's contributions. While some of the cost of future Social Security benefits are prefunded in its trust fund, the program is an example of a pay-as-you-go retirement system in the United States since most of the benefits are paid out of the contributions made on behalf of workers today. By contrast, defined benefit pension plans in the private sector and in state and local government are generally pre-funded systems.

Pension*

Steady income given to a person as the result of service (e.g., employee, military) that begins when a specific event (e.g., disability, retirement) occurs. Pensions are typically paid monthly and based on factors such as years of service and prior compensation. The payment may be made by a government, employer, pension fund, or life insurance company.

Pre-funded retirement system

A system in which the benefits to be paid during retirement are paid for before retirement begins. Typically, regular contributions for each worker are made into a retirement fund during the course of that worker's career, starting with the first paycheck and continuing until the last. These contributions are invested, and contributions plus accumulated investment earnings pay for benefits in retirement.

R

Replacement ratio (replacement rate)

Ratio that compares a household's post-retirement income from all sources (Social Security, pensions, and savings) to its income before retirement. The replacement ratio is a common measure of determining retirement income adequacy. Most experts believe that a replacement ratio of about 80% or higher is needed for middle-class Americans to maintain their pre-retirement standard of living in retirement.

S

Smoothing

The process of amortizing investment gains and losses over a period of time. For example, rather than using the market value of a fund's assets in determining the ARC, actuaries will calculate an actuarial value of assets, by taking, for example, a five year average of assets. This can help to reduce volatility in contribution rates.

T

Trustee*

A person, bank, or trust company that has responsibility over the receipt, disbursement and investment of property or funds for the benefit of another party. When this responsibility is not exercised by a bank or trust company, it is usually exercised by a board of trustees with each trustee given one vote.

U

Unfunded actuarial accrued liability (UAAL)*

An actuarial accrued liability that exceeds the actuarial value of fund assets. If the value is negative, it is referred to as a negative unfunded actuarial accrued liability, or a funding excess. Also referred to as unfunded actuarial liability, or funding gap.

V

Vesting*

The process by which a participant obtains nonforfeitable rights to benefits, such as an employee retirement plan. Typically, these rights accrue based on an employee's years of service to an employer. Vesting can also refer to a set period of time (such as 60 days) before an heir specified in a will can inherit.

* Excerpted from Benefits and Compensation Glossary, 12th Edition, copyright 2010, International Foundation of Employee Benefit Plans, Brookfield, Wis. Copies of the book are available for purchase by calling 888-334-3327, option 4.