What is a Pension Equity Plan?

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Originally Posted:October 29, 2003

To meet the needs of workers who hold a number of jobs throughout their lives, employers continue to seek new kinds of retirement income plans; pension equity plans, like cash balance plans, let employees know the lump-sum value of their pension while they are still working.

Traditional defined benefit pension plans have been described as "golden handcuffs," providing generous ("golden") retirement income to workers who remain with the same employer (the "handcuffs") throughout their work life. Such plans, which often base benefits on earnings in a worker's last years with the company, may provide lower benefits for those employees who work in multiple jobs throughout their lifetimes. In January 2002, employees had worked for their current employer for an average of 3.7 years; those aged 45 to 54 had worked for their current employer an average of 7.6 years.[1] These data suggest workers may be accumulating retirement benefits from several jobs; employers have attempted to deal with these changing needs by seeking alternative approaches to providing retirement income.

The different career plans of the younger generations have led many employers to conclude that their retirement plans were not beneficial to these younger, more mobile workers. This was not conducive to attracting potentially valuable employees that could help increase efficiency.[2]

One new approach is the pension equity plan, which is a defined benefit plan that builds cash value throughout a person's working life. Much like cash balance pension plans,[3] which have received considerable attention in recent years, pension equity plans offer the guaranteed benefits of a defined benefit plan while expressing benefits in terms of a current lump sum, which mobile employees can access when they leave their employer. (See the appendix for a comparison of cash balance plans and pension equity plans.)

When designing retirement benefits, today's employers may face different issues than were faced in the past. Consider some of the needs of today's employers:[4]

- The ability to recruit new employees that are well into their careers
- The ability to provide predictable retirement benefits
- The ability to accommodate early retirement
- The ability to provide portable benefits upon employment termination or retirement
- The ability to provide benefits that keep up with inflation

To meet these needs, new, hybrid forms of pension plans--including pension equity plans and cash balance plans--have been developed. Such plans are referred to as "hybrids" because, even though they are defined benefit plans, they combine the features of both defined benefit and defined contribution plans. A defined benefit plan typically includes a formula for computing benefits at retirement. Benefits are often based on salary and length of service; employers are required by law to place sufficient funds in the plan to pay for future benefits. The Federal government guarantees benefit payments, within limits. In contrast, a defined contribution plan specifies contributions, or ranges of contributions, from employers and employees. The contribution is often stated as a percentage of the employee's salary; all funds go into an individual account designated for the employee. The fund balance, including investment earnings, is paid to the employee at retirement. Unlike a defined benefit plan, the risk of investment loss in a defined contribution plan is borne by the employee.

Hybrid plans began to emerge in the late 1980s with the introduction of cash balance plans. Hybrid plans generally specify contributions to an account (or balance) like a defined contribution plan, but guarantee final benefits like a defined benefit plan. Such plans grow throughout an employee's career and allow employees to see that growth through an account balance.[5]

The key difference between defined contribution plans and hybrid plans is that defined contribution plans establish an actual account for each participant while hybrid plans use a theoretical account that does not actually accrue funds. A defined contribution account accumulates the actual funds contributed by the employee and employer, and the account changes with investment earnings and losses. The account in a hybrid plan is theoretical and is not actually funded by employer contributions. The employee receives credits each year and the account balance grows, but the employer contributes to the plan as a whole (covering all workers in the plan) to ensure that sufficient funds will be available to pay all benefits. The employer's contribution in a given year may be more or less than what is credited to an individual employee's account.

Among the first pension equity plans was the plan designed for RJR Nabisco and introduced in 1993.[6] BLS data indicate that, of the 22 percent of full-time private industry workers with a defined benefit pension plan in 2000, 3 percent participated in pension equity plans. In 1997, about 1 percent of full-time workers in larger private companies with a defined benefit pension plan were in a pension equity plan. While the incidence of pension equity plans remains very low, other hybrid plans have grown rapidly, perhaps suggesting that more pension equity plans will be seen in the future. In 2000, for example, 1 in 4 full-time private industry workers with a defined benefit pension plan was in a cash balance plan, up from 1 percent in 1988 and 6 percent in 1997.[7]

Plan Design

A pension equity plan is a defined benefit plan that provides an annuity or lump-sum benefit at the termination of a participant's employment. Pension equity plans define benefits in terms of a current lump-sum value. Annual credits can be based on age, service, or a combination of both. The plan determines the total benefits by providing a "schedule of percents" that are accumulated throughout the work life of the employee. When an employee leaves the employer, either at retirement or at any time once vested, the accumulated percentage is applied to final earnings (defined by the plan) to determine a lump-sum benefit.

The following tabulation shows an example of how a pension equity plan might accumulate percents of earnings strictly on the basis of age:

Age	Percent of earnings accumulated
29 and younger	2.5
30 to 35	3.0
36 to 40	4.0
41 to 45	5.0
46 to 50	6.5
51 to 55	8.5
56 to 60	10.5
61 and older	13.5

Employees receive a percent of earnings credits for each year of service, which are accumulated throughout the employee's career with the employer. The total percent (shown as a credit in some plans) is multiplied by the employee's final average earnings. Final average earnings generally are defined as an annual average of the highest earnings over a specific number of years--for example the average of the highest 3 years of earnings.

Table 1 illustrates how three different workers would accumulate benefits under a pension equity plan. Each employee leaves the company with the same final average earnings (as defined by the plan), but the amount of their actual lump-sum benefit--and consequently their annuity value--differs considerably because of differences in their ages and lengths of service. Because the benefit credits accumulate more quickly for older workers, employee 1 with 15 years of service at age 40 has a smaller lump-sum benefit than does employee 3, who has 15 years of service at age 65. The employee with 30 years of service who retires at age 65 has the greatest accumulation, reflecting both long service and nearness to retirement age.

Employers may use alternative approaches to determining credits under a pension equity plan. For example, an employer with multiple lines of business can adjust the percents to accommodate many different types of workers. Table 2 shows an example of this flexibility. In this example, the plan includes three different schedules of percents for three different occupational groups within the same company.[8]

Pension equity plans can vary their accrual rate based on both age and service, and they can provide different accruals for those earning more than the Social Security taxable wage base. For example, an employer can provide a standard age-based accrual and add to that a smaller accrual based on service. Employees with 10 to 20 years of service might receive an additional service accrual of 2 percent per year, while those with more than 20 years of service might receive an additional 3 percent per year.

Defined benefit pension plans are also allowed to "integrate" benefits with Social Security; such a provision takes into account the employer funding of Social Security benefits up to an annual threshold (the Social Security taxable wage base). A pension equity plan might vary its accruals for those earning less than or more than the wage base. For example, a plan that accrued 3 percent of earnings per year for those aged 31 to 40 might increase that accrual to 5 percent per year for those earnings that exceed the wage base.

Distributions

While pension equity plans identify their benefits in terms of a lump sum (a percent multiplied by final earnings), as a defined benefit plan they must make benefits available in the form of an annuity. In practice, this annuity requirement is typically only applicable to workers who are nearing retirement age. By law, defined benefit plans with a value of $5,000 or less can, without the consent of the covered employee, pay the employee a lump sum and not offer an annuity option. In a traditional defined benefit plan, such value is determined by the present value of future benefits. In a hybrid plan, the value is the actual account balance.

Workers whose account value is greater than $5,000 must be offered the option of an annuity; in fact, the standard form of benefit for a married employee must be a joint-and-survivor annuity. Only if both the employee and spouse waive the right to a joint-and-survivor annuity can the benefit be paid out in another way, such as a lump sum.

While hybrid plans are designed to allow workers to know the value of their retirement benefits at any time, and to have easy access to the lump-sum value of those benefits should they leave their employer, receipt of retirement benefits prior to retirement age can have adverse tax consequences. Such distributions are considered taxable income in the year they are received. The distribution may also be subject to a 10-percent Federal tax penalty for early receipt of retirement benefits, depending upon the employee’s age. To avoid such taxes, the employee terminating employment and moving on to another job can roll over the lump-sum benefit into an Individual Retirement Account (IRA) or a retirement plan sponsored by a future employer.

Pension Equity Plan Advantages

The ability of employees to know the current value of their plans at any time is one of the advantages of pension equity plans. Another perceived advantage is that there is no reduction in benefits due to early retirement. This means that if a worker terminates his or her employment before normal retirement age, but has fulfilled the vesting requirements, the benefit will reflect the length of time worked. In contrast, a traditional defined benefit pension plan specifies periodic pension distributions as the amount available at normal retirement age. Employees receiving benefits before that age typically receive lower benefits to account for receiving benefits over a longer expected lifetime. While this early retirement "reduction" is considered a penalty by some, it is in fact merely an adjustment based on life expectancy. (Some employers subsidize that adjustment by making the reduction less than a true actuarial reduction.) No such adjustment occurs in a pension equity plan. Because benefit accruals typically rise with age, however, the pension equity plan formula already has adjustment for age built into the accrual formula.

While pension equity plans and cash balance plans share methods of accumulating value, a major difference is the earnings used to determine the benefit. Cash balance plans specify a credit each year, based on that year's earnings. By contrast, in a pension equity plan, the credits are applied to final earnings. This feature provides built-in inflation protection. Regardless of whether an employee has just a few years of service required for vesting or has worked under the plan an entire career, benefits are based on earnings at the end of the employee's career.

Through its annual benefits survey, BLS has tracked the change in retirement plans over time, from traditional defined benefit to defined contribution to hybrid plans. BLS will continue to monitor and report on the incidence of pension equity plans.

Appendix. Comparison Of Features Of Pension Equity Plans And Cash Balance Plans

Feature	Pension Equity Plan	Cash Balance Plan
Benefit formula	Percent of earnings, may vary by age, service, or earnings	Percent of earnings, may vary by age, service, or earnings
How benefits are accumulated	Percent of earnings, as determined by the benefit formula, are accumulated each year, but the final benefit is not determined until employee leaves the plan	Dollar amount (benefit formula times earnings) placed in hypothetical account each year; interest on account balance also credited each year
Definition of earnings	Total accumulated benefit applied to final earnings, as defined by the plan; final earnings typically those in last 3-5 years before retirement	Percent applied to each year's earnings
How to determine value of benefits for current employees	Employees can multiply their accumulated percent of earnings times their final earnings as defined by the plan to determine their current benefit	Account balance is the current benefit
Distribution	Specified as a lump sum, but can be converted to an annuity	Specified as a lump sum, but can be converted to an annuity

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Notes

1 *Employee Tenure in 2002*, USDL 02-531 (U.S. Department of Labor), September 19, 2002.

2 For a discussion of hybrid plans and the current work force, see Lindsay Wyatt, "Hybrid Plans Fit Evolving Work Force" *Pension Management*, March 1996, pp. 12-18.

3 For a discussion of cash balance pension plans, see Kenneth R. Elliott and James H. Moore, Jr., "Cash Balance Pension Plans: The New Wave," *Compensation and Working Conditions*, Summer 2000, pp. 3-11.

4 Much of the discussion on employer objectives is taken from Charles D. Spencer & Associates, Inc., "Pension Equity Plans: Comparison of Plan Features Reveals Ability to Satisfy Mid-Career New Hires," *Spencer's Research Reports on Employee Benefits* (Chicago, IL, Charles D. Spencer & Associates, Inc. July 8, 1994).

5 For a discussion of hybrid plans, see Robert L. Clark, John J. Haley, and Sylvester J. Schieber, "Adopting Hybrid Pension Plans: Financial and Communications Issues," *Benefits Quarterly*, First Quarter 2001, pp. 7-17.

6 For information on early Pension Equity Plans, see "More Employers Choosing Pension Equity Plans," *Watson Wyatt Insider*, June 1996. See also "Hybrid Retirement Plans: The Retirement Income System Continues to Evolve," EBRI Issue Brief No. 171, (Employee Benefit Research Institute), March 1996.

7 Data are from the BLS surveys of employee benefits. Data for 1988 and 1997 are for full-time workers in large private establishments (those with 100 or more workers). Data for 2000 are for full-time workers in all private establishments, regardless of employment. Other sources indicate growth in hybrid plans as well. Data from Watson Wyatt International, for example, indicate that 22 percent of Fortune 100 companies offered hybrid pension plans in 1998; by 2000, the figure had risen to 32 percent. See Watson Wyatt Worldwide, on the Internet at http://watsonwyatt.com/news/press.asp?ID=6820

8 For more examples of variations in pension equity plans, see "More Employers Choosing Pension Equity Plans," *Watson Wyatt Insider*, 1996, pp. 7-9.

Table 1. Accumulation of benefit credits and calculation of lump-sum and annuity values under a Pension Equity Plan

	Employee 1	Employee 2	Employee 3
Age at hire	25	35	50
Age at separation	40	65	65
Total years of service	15	30	15
Credits per year:			
Age 30 and younger (2.5 percent)	5 @ 2.5 = 12.5	0	0
Age 31-35 (3.0 percent)	5 @ 3.0 = 15.0	0	0
Age 36-40 (4.0 percent)	5 @ 4.0 = 20.0	5 @ 4.0 = 20.0	0
Age 41-45 (5.0 percent)	0	5 @ 5.0 = 25.0	0
Age 46-50 (6.5 percent)	0	5 @ 6.5 = 32.5	0
Age 51-55 (8.0 percent)	0	5 @ 8.0 = 40.0	5 @ 8.0 = 40.0
Age 56-60 (10.5 percent)	0	5 @ 10.5 = 52.5	5 @ 10.5 = 52.5
Age 61 and older (13.5 percent)	0	5 @ 13.5 = 67.5	5 @ 13.5 = 67.5
Total credits (percent)	47.5	237.5	160.0
Final average earnings (1)	40,000	$40,000	$40,000
Lump-sum benefit	$19,000	$95,000	$64,000

Footnotes:
(1) As defined by the plan.

Table 2. Examples of pension equity plan credits that vary by occupation

Age	Percent of earnings accumulated		
	Job group 1	Job group 2	Job group 3
29 and younger	1.5	2.8	5.0
30-39	2.5	3.8	7.0
40-49	4.0	5.0	13.0
50-59	5.5	8.0	18.0
60 and older	6.0	11.0	22.0