You and Your Pension: A Powerful Combination *by Steve Waas, CFP®, EA*

If you have been following the news, you have probably noticed that there has been a growing movement both nationally and in the state of Texas to eliminate DB plans and replace them with 401(k)-style defined contribution (DC) plans that instead restrict members to individual separate accounts. This campaign will probably accelerate over the next couple of years.

Should you care?

YES.

It is common for opponents of DB plans to point to private sector retirement plans as a model. In the private sector, DB plans have been increasingly replaced with DC plans. Often the end result has been to cut overall compensation in ways that were not well understood by the affected employees. This is because comparing DB and DC benefits is a very complex task.

To see this, consider a typical HMEPS retiree. The average annual annuity for an HMEPS retiree is less than $24,000 per year. Without a DB plan, how much savings would a 65 year old worker need to be able to generate this income for the rest of his life? About $550,000.

Over a 30 year career, this worker would need to save at least 26% of his salary, each and every year, in order to end up with this much savings. This assumes he earns, when near retirement, about $35,000 a year and that he invests very successfully.

Considering that the median 401(k) match in the private sector is about 2%, it's not hard to see why many people have fallen so far behind in their retirement plans – often not realizing it until they want to retire.

Switching from DB to DC usually involves providing a "lump sum" of money to the participant. Presumably, this represents the value of the forgone DB benefit. Lump sums seem to be irresistible to people, regardless of what it costs them. Many companies in the 1990s exploited this common tendency while quietly cutting pension obligations.

One study of a huge lump sum payout program from a pension plan in 1992 showed that thousands of workers, by taking immediate lump sums instead of future monthly payouts, effectively turned down guaranteed rates of return of nearly 20 percent per year. The researchers calculated that this translated into a net transfer of $1.7 billion from the employees to the employer.

DB pensions are often viewed by critics as an excessively "expensive" component of compensation. But the simple fact is that retirement is expensive. Instead of coming to terms with this fact, Americans are cycling through various alternatives in the hopes that one of them will somehow render retirement cheap. Here are some of these "solutions":

- ***Rely entirely upon 401(k)-style accounts, since they are a much cheaper way to save for retirement.*** But a closer look reveals that these accounts are not cheaper and have left millions of Americans with drastically underfunded retirement accounts. (To learn more, see "Why Pensions Work" at www.hmeps.org and click on Resources: Learn More About Pension Issues.)
- ***All we need to do is raise retirement ages, since life expectancies have risen.*** Raising retirement ages may be appropriate in some cases, but this is not the general solution that many people seem to think it is. First, while life expectancies have indeed increased, we must also recognize that health conditions vary significantly among older workers. Retirement is not always a matter of choice. Furthermore, while many people have nice, indoor jobs in air conditioned offices, society still depends on millions of workers in physically demanding jobs such as hauling garbage, fixing roads, fighting fires and chasing criminals. Expecting all of these workers to continue these jobs into their 60s may not be realistic.

As with any program or system, unexpected challenges can arise. When necessary, state and local governments have taken steps to modify the design of their plans, in order to accommodate changing circumstances and needs. HMEPS has taken concrete steps to improve the pension system and has continued to pursue responsible pension reform.

At the end of the day, saving for retirement is both necessary and expensive. This will be true regardless of the approach. A reasonably structured DB pension remains a highly efficient way to deliver the core financing that people need for retirement.

If our common goal is achieving adequate retirement security, then we need to be concerned and vigilant about the increased efforts to replace traditional defined benefit pension plans with 401(k)-style plans. What's at stake is your retirement security and your ability to live the future you have earned.

Steve Waas is a Certified Financial Planner and the HMEPS Financial Counselor. Steve is available for individual meetings with participants and also discusses financial topics in our newsletters to help participants better understand these important issues.