Retirement: Defined Benefit Plans

How Does My Defined Benefit Pension Plan Work?

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The Defined Benefit Plan used to be the standard for pension plans. Over the last 10 years, many companies have been phasing out these plans in favour of Defined Contribution Plans. Some companies may give you the option of switching between them as well, or converting from one type to another. This article is focused on the Defined Benefit Plan. To find out more about the Defined Contribution Plan, see my last article on my web site link: http://www.joetheinvestor.ca/Written_Articles.html entitled “What Do I Do With My Defined Contribution Plan?” If you start working for a company today, you will most likely be offered a Defined Contribution Plan unless you work for the public sector, a unionized environment, or a company with a long standing defined benefit plan.

How do I know the difference between the two plans? See the definitions below. The **words in bold are terminology** you will often see in the discussion of defined benefit pension plans.

Defined Benefit and Defined Contribution Plans Defined

A **defined benefit plan** is a pension plan where the <u>future payout in retirement</u> is defined by a set formula when you join the company. It is a calculation that usually includes your highest average salary, time working in the company, and how much money was contributed by you and the employer. The money is invested on your behalf and the firm is responsible for risk if something goes wrong. There is usually an implied rate of return that is guaranteed by your employer each year, which is the investment rate of return your money would earn if you could see your pension plan in a bank account.

A **defined contribution plan** is where the <u>money you pay into the plan</u> is defined: the amount contributed either by you or on your behalf by the company. It is a set dollar amount based on your salary in the year that you are working. You can think of it as the company (and sometimes you and the company) contributing to your pension account. This is similar to a Registered Retirement Savings Plan (RRSP) account, except that it is locked in. Locked in means that the money is in your name and you are entitled to the money, but cannot withdraw it unless there is a very exceptional circumstance. (i.e. this is the only money I have and I need to pay my bills). Also like an RRSP Account, you get to choose the investments in the defined contribution scenario, and you are taking the risks. If you invest in a fund and it loses money, you must deal with the consequences. It is for this reason that it is good to have a plan. If you are in a situation where you have a defined contribution account, you will have to make the decisions.

I know that I have a Defined Benefit Plan, What Now?

The good news is that defined benefit plans tend to work without many decisions being made on your part. This article is designed to make you aware of how they work so that you can be aware of potential changes and make decisions such as benefits changes, whether to stay at your employer a certain number of years, whether to transfer your pension to another institution, or convert to another type of plan (i.e. The Defined Contribution Plan). You may also be given warning if the promises that were made to you when you joined the pension plan get changed by the time you actually receive payment in retirement.

How Does It Work?

A defined benefit pension plan is basically a giant bank account, covering retirement for many employees in an organization over a long period of time. The employees and the employer contribute money every year, and this money is collected in this account. The entity that manages this bank account is called the **plan sponsor**. This account is typically run separately from the company operations, or from the institution it represents. For example, the GM pension plan is a separate entity from GM the corporation. The only relationship the pension plan and the underlying company should have is for company contributions, adding money to increase funding of the plan, or removing money over and above the projected amount needed to pay the present and future pensioners. If there is any other money transfer between the pension plan and the company, this should be monitored as it may signal funding problems, or a permanent change in the structure of the pension plan (for example company mergers, amalgamations or division split off from the parent company).
Once money is deposited into this bank account, it is invested for a long period of time to ensure that there is enough money to pay the future obligation. The amount of money promised to future pensioners is tabulated, and this amount is **discounted** back to the present, using an interest rate called a **discount rate**. This means that an equivalent amount of money invested in the current year is calculated to equal this expected future obligation. The calculation of the future obligation determines an **expected rate of return** which is the return necessary for the money sitting in the bank account to pay the future obligation and operate the pension plan. How do they know how much they will have to pay? This is where **the actuary** comes in. The actuary estimates how long people will contribute and withdraw money from the pension plan based on life expectancy, economic conditions, expenses of running the plan, the investment returns and inflation among other things to come up with a **projected benefit obligation**. The current health of the plan overall is measured using an **asset-liability study,** which is exactly what it sounds like – a study of the **assets** (money expected to be generated by the plan) and the **liabilities** (money that is expected to be paid out by the plan), or the **funding** situation of the pension plan. There can different versions of this calculation due to varying assumptions. If you are very keen, you can find the assumptions in the financial reports of your pension plan and see what the variations are. Since these calculations are projecting way out into the future, a small change in an assumption will mean a big change in the result. Keep an eye on this over the years to see what trends may be impacting the numbers. This asset-liability study also determines whether there is a **surplus** in the plan, or it is **overfunded** (more money

in the plan that the most current estimate requires to cover the future obligation) or a **deficit** in the plan, or it is **underfunded** (less money in the plan than the most current estimate requires to cover the future obligation). If a deficit becomes too large and stays there for a period of time, the plan may become **insolvent.** This is very similar to a company that goes insolvent because it ran out of cash and couldn't sustain its business any longer. If this happens, the government may bail out the plan, but this depends on the jurisdiction, funds available and willingness of the government. The alternative is to **wind up** the plan and whatever money is left over is divided among the stakeholders (the pensioners, contributors and entities that operate the plan). This is similar to a bankruptcy proceeding for a corporation.

Contributions

Contributions represent the money put into the pension plan by you and your employer. The contribution amount is usually based on a percentage of salary, and consequently the payout in retirement is also based on your salary. The specific calculation of the payout will vary for each plan – this should be checked with your employer. The retirement calculators provided at your workplace are very handy for figuring out your projected retirement monthly payout. Since the numbers are projecting well out into the future, unless you are within 5 years of your retirement, the numbers will likely change by the time you actually receive payments. The ratio of money you are contributing versus the employer will vary by plan and over time. Generally, the less you contribute, the better off you are if you receive the same benefits. Check your pay stub to make sure that the amount deducted equals the amount that should be deducted. If it is not, ask why. There may be some additional deductions or changes to the percentages that you may not be aware of. In some plans, you don't see what the employer contributes – you only see what you have contributed. If you know the percentages of both parties, you can figure out how much you are actually getting. Also, for tax purposes, the company will reflect contributions from both parties on your tax slips, as the total dollar amount will impact RRSP contribution room and tax planning. Changes to contributions and benefits are usually reflected after union contract negotiations, or after asset–liability studies are carried out which determine how much money the plan will need to pay the pensioners, and how much you the contributor will need to pay.

Vesting

"Vesting" or "Vesting Period" is the time after which you are entitled to benefits or payment, either now or in the future. When you first join a pension plan, the first vesting period is the time when you are entitled to the employer contributions. It could be your first day of employment, or months and years out into the future from your first day of employment. There may be other vesting periods – times at which you are entitled to pension payments, or health benefits as well as pension payouts. Many defined benefit pension plans will include access to health insurance, and how much is covered is typically what you receive when you are working – but this varies and must be verified with your employer. There may be a vesting period for when you can take early retirement. This is usually called early retirement rather than vesting, but the idea is the same. If you stop contributing to the pension plan, you will lose anything that is not vested. Note that you may leave the company and return to the company but continue contributing in your absence. Whatever is vested can either be taken with you, or received as a deferred payment in the future. The tabulations that are done with the retirement calculators always assume you will contribute all the way up to your retirement without interruption. If you leave earlier, you need to calculate a **deferred payment**, where you input the start and stop date of your contributions, and how much money you put in over this period. If you are familiar with the concept of an annuity, this is very similar.

Indexing

When most pension calculations are done, it is assumed that there is no inflation in the numbers. If you see the term **"real rate of return",** this interest rate would include inflation, and would equal the **nominal rate of return**, or typical interest rate that is quoted, minus the inflation rate. As an example, if you received a 5% return on your mutual fund last year, and the inflation rate was 2%, your real rate of return would be 5%-2% or 3%. Why does this matter? Typically pension payments are fixed – once a payment is calculated upon reaching retirement, it stays the same throughout retirement. The problem is that when you retire, you are supposed to have enough money to pay your expenses with this pension payout. If the rate of inflation is 2% every year up to your retirement, this is like saying you can buy 2% less stuff every year. If the promised pension payment is $2000 per month today, and you retire in 20 years, this 2% inflation rate would reduce the amount of stuff you can buy by 40% (2% x 20 years). If this continues while you are retired, say another 20 years, this money will now buy 80% less stuff than today. Imagine paying bills with 80% less money! **Indexing** raises the payout calculations by the amount of the inflation rate to prevent this erosion of monetary value from happening. Inflation is actually a very personal thing – the price increases of the stuff you personally spend your money on, is what will impact you the most. The pension plans assume that you buy the same quantity of stuff and in the same proportions as the average, or quoted inflation rate. This is likely not true, but it is better than no indexing at all. Some pension plans also have a maximum amount that they will index, or will not fully index but only partially. Check with your employer for the calculation to verify.

Early Retirement Special Features

Most plans have an option to retire early. They will usually combine how long you have worked there, or **years of service** with your age and determine a threshold for qualification for early retirement. If you retire early, the rules may change. They may give you a reduced pension for a period of time, or some other benefit. This is highly specific to your employer, so do the homework on this one. These features also change over time. The more the employer wants you to retire, the better an offer they will provide. Another indicator is that the more money the pension plan has, or the better the funding situation, the lower the contributions will be and the better the early retirement terms will be. The closer you are to retirement, the more these features will impact you. Retiring early is a very personal decision, as it will affect your retirement plan, tax status, income and employability. Make sure you plan carefully if you are offered early retirement, and do what is best for your needs.

RRSP Effect

The government views all of your pension accounts together when it comes to contribution room. The RRSP room that you are allowed will include defined benefit pension plan room, as well as all other types of retirement accounts. As an example, if you are allowed $12000 worth of RRSP room, and the defined benefit plan contributes $10000 in the relevant tax year (note that this includes your contributions and those of the company), you would have $2000 left for additional contributions to another type of retirement account.

What About the CPP?

The CPP contributions are also accounted for with your defined pension plan. The employer will account for the CPP limits when calculating your defined pension contributions. When you retire, the pension calculator that you use to determine how much money you receive in retirement accounts for CPP entitlements as well. How this accounting is done will depend on your salary and the CPP contribution calculations for the year in question. This would be another question for your employer. When you are retired, you would receive the CPP Payment and the Defined Benefit Pension payment separately, and the Old Age Supplement (OAS) if applicable.

What if I Leave the Company?

If you leave the company and you are vested, you can leave the money with your former employer, or take it with you to another institution. If you leave it with your employer, you will be able to receive it when you reach retirement age – this is called a "**deferred payment**". It may also mean a series of payments over time – this is something I would ask the employer, especially if you will be retiring in the next 10 years. Since it is a pension plan, it will remain locked in until you are of retirement age. It would be kept separate from other non-locked in assets that you might have – like RRSPs, Tax Free Savings Accounts (TFSAs) or non-registered (cash) accounts. There are situations when you can combine locked in accounts from different employers into a single account. This should also be discussed with your current employer.

You can also combine defined contribution and defined benefit plans together in certain situations - if your current employer has a way of calculating the value of the contributions between the two (or more) types of plans. This is also possible between defined benefit plans of different types. Please ask your employer for the rules of their pension plan upon arriving or leaving a job to make sure you have all of the options open. You can also manage pension money yourself once you leave the employer. The money would go into a Locked in Retirement Account (LIRA), which can be managed by the same financial institutions that manage RRSP accounts. You can also turn this money over to a financial planner or broker if you believe they can manage your money more effectively than you can. There are usually time restrictions on making these transfers, and rules of protocol to follow, so please ask your company when you leave the firm and get the proper procedure so you can implement this strategy if you want to.

What If I Am Not Vested Yet?

If you leave the company before the vesting date - your funds will be returned to you but employer contributions will be kept by the company. For information purposes, keep track of how much you and the company contribute from when you joined the plan in the event of mistakes. As an aside, always keep your statements and print out hard copies of your records in case of issues with accessing your internet based accounts or loss of history. At the very least, have the records stored in your personal hard drive so they can be accessed without restriction. This is also a good idea for tax purposes. You want to be able to recreate your account situation from start to finish without relying on the internet, or any other parties to supply you with information.

In summation, the defined benefit pension plan is an integral part of your retirement. Even though it is managed by your employer, you should know what is going on and make decisions when appropriate.

Sources:

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