

A PREDICTABLE, SECURE PENSION FOR LIFE

Defined Benefit Pensions



There are a variety of pension plans offered by private sector employers today. This publication offers a handy explanation of traditional defined benefit pension plans insured by PBGC: what they are, how they operate, and the rights and options of the workers covered by them.

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Traditional Pension Plans

The first private pension plan in the United States was established in 1875 by the American Express Company and was soon followed by pensions provided by utilities, banking, and manufacturing companies. Almost all of the early pension plans were traditional pension plans — known as defined benefit plans — that paid workers a specific monthly benefit at retirement.

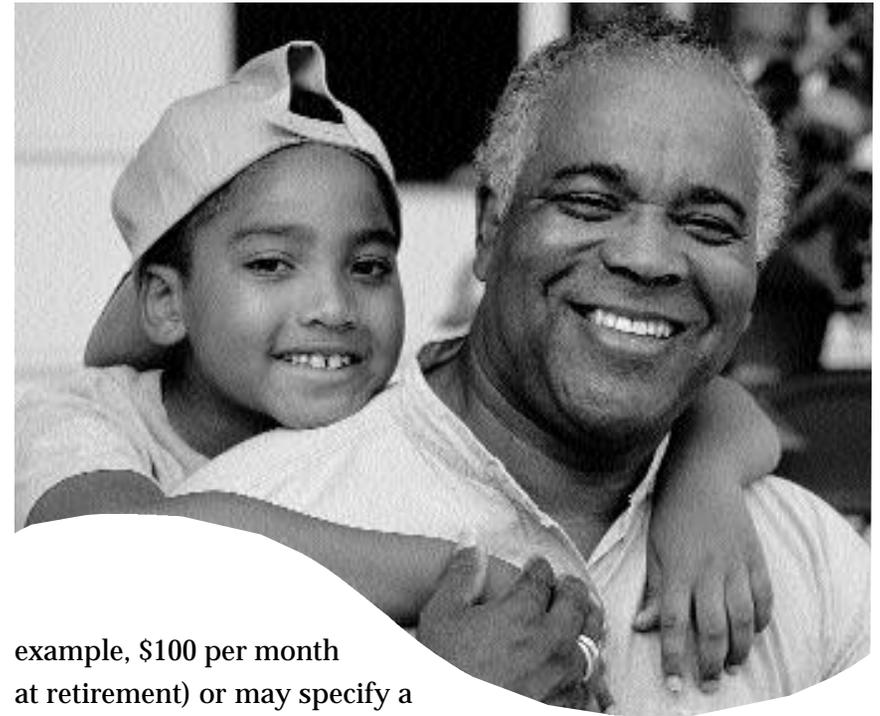
Until 1974, there was little or no protection for pensions. Because of shocking instances of workers losing their retirement benefits (most notably in 1963 when 4,000 Studebaker auto workers lost some or all of their promised benefits), Congress in 1974 took action to prevent such tragedies by enacting the Employee Retirement Income Security Act (ERISA).

ERISA set strict requirements for private pension plans. The U.S. Department of Labor (DOL) is responsible for seeing that pension plans are properly operated and that their assets are managed in a prudent manner. The Internal Revenue

Service (IRS) is responsible for pension plan funding and vesting requirements, and for ensuring compliance with tax laws. ERISA also established the Pension Benefit Guaranty Corporation (PBGC) to insure the pensions of workers covered by private defined benefit pension plans.

Defined benefit pension plans may state the promised benefit as an exact dollar amount (for

Most private defined benefit plans are insured by PBGC.



example, \$100 per month at retirement) or may specify a formula for calculating the benefit (for example, \$10 per month for every year of service with the company, or a percent of a worker's salary times years of service). Generally, a company funds the pension plan and plan assets are invested, usually by a professional money manager. Importantly, most private defined benefit plans are insured by PBGC.

A defined benefit plan can be either a single-employer plan

or a multiemployer plan. A single-employer plan, which may be collectively bargained, provides benefits for workers of one employer. A multiemployer plan is a collectively bargained pension arrangement involving more than one unrelated employer, usually in a common industry, such as construction, trucking, textiles, and coal mining.

Predictable, Secure Lifetime Benefits

Defined benefit pension plans offer workers a number of advantages when compared to other workplace retirement plans. They provide workers with a predictable and secure benefit for life.

Predictable Benefits:

- Workers are promised a specific benefit at retirement.
- Workers can know in advance what benefits they will receive.
- The benefits of workers are certain, not subject to the fluctuations of the stock and bond markets.
- Employers, not workers, are responsible for providing the retirement benefits, and the benefits are not dependent upon the amount of salary workers are willing or able to contribute.

Secure Benefits:

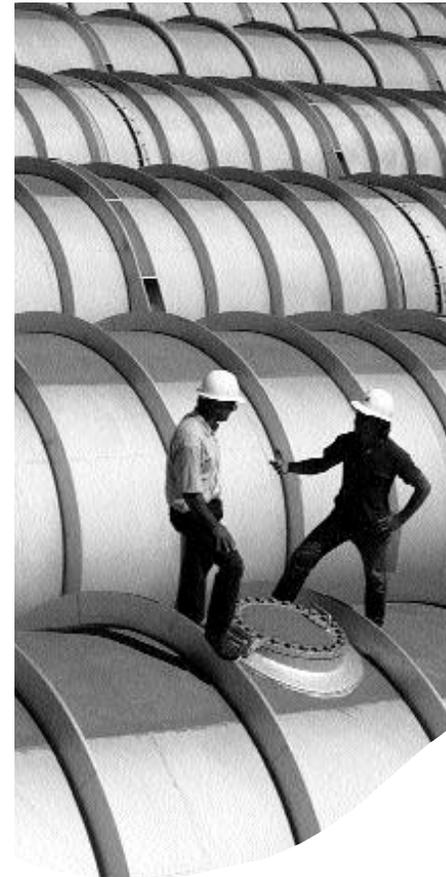
- PBGC pays the worker's pension up to guaranteed limits if the employer cannot afford to pay the benefits or goes

out of business. In most cases, the PBGC guarantee covers all of the earned benefit.

- A worker can earn a reasonable retirement benefit under a defined benefit plan, even if the worker has not had an adequate retirement plan or was not covered by a retirement plan earlier in a career.

Lifetime Benefits:

- A defined benefit plan must offer to pay an annuity, a monthly benefit, for the life of a retired worker, no matter how long the worker lives. If the value of the benefit is \$5,000 or less, the plan may pay the benefit in a single payment.



The Pension Benefit Guaranty Corporation pays the worker's pension up to guaranteed limits if the employer cannot afford to pay the benefits or goes out of business.

Additional Benefit Possibilities:

- If a worker is married, a defined benefit plan must also pay an annuity to the worker's surviving spouse for the spouse's life, unless the worker and spouse elect otherwise.
- Defined benefit plans can provide additional valuable benefits to workers, such as early retirement benefits, extra spousal benefits, disability benefits, or cost-of-living adjustments.

Trends

There have been some major shifts recently in America's pension system. While the number of workers covered by traditional defined benefit pensions has remained relatively level, there has been significant growth in defined contribution pension plans, especially 401(k) plans. Many employers began offering workers both a defined benefit plan and a 401(k) plan. Other employers offer only 401(k) plans.

Workers in 401(k) plans have individual accounts, which are funded with worker contributions and include a matching or other contribution by the employer. The ultimate benefit depends primarily upon the amounts contributed and the returns on the investments chosen by the workers. PBGC does not insure defined contribution plans.

A more recent trend, especially among large employers, has been to convert traditional defined benefit plans to "hybrid" pension plans, such as cash balance plans. These hybrid plans are defined benefit plans and are insured by PBGC.

The retirement benefit in a cash balance plan is generally described in terms of a hypothetical account balance that looks like the account balance in a 401(k) plan. In this hypothetical account, a worker accumulates pay credits (usually a percentage of pay) and interest credits (usually a percentage of the total account balance). The interest credit is frequently based on the interest rate on a U.S. Treasury security. The pay and interest credits, specified in the plan, resemble the actual contributions and earnings to a worker's account under a 401(k) plan. Because cash balance plans are hybrid defined benefit plans, they offer a predictable benefit at retirement.



Cash balance plans contain many of the important advantages of traditional defined benefit plans:

- benefits do not depend on how much a worker is willing or able to contribute;
- the employer bears the investment risk;
- plans must offer an annuity with a survivor benefit; and
- benefits are insured by PBGC.

Cash balance plans also have features that traditional defined benefit plans do not:

- workers can know the value of their benefits and tend to understand them better when expressed as a hypothetical individual account;
- younger workers and shorter-service workers, who are often women, can receive higher benefits; and
- workers who do not spend their full careers with one employer have more portable benefits that can be transferred to another plan.

However, cash balance plans also:

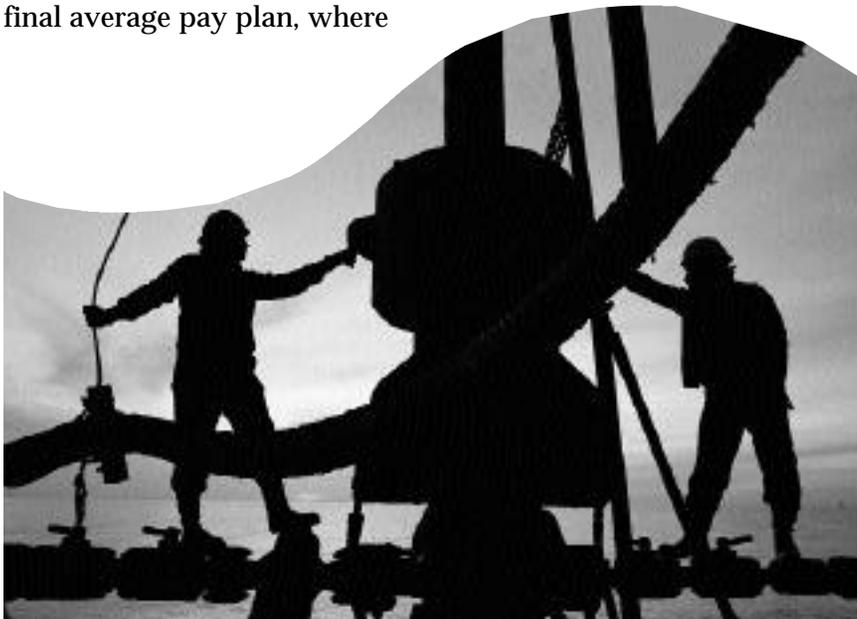
- frequently offer a single, lump-sum payment, which workers often take and spend rather than rolling it over and saving for their retirement; and
- generally do not offer subsidized early retirement benefits, making it harder for workers to retire early.

Many cash balance plans are conversions from traditional defined benefit plans.

Conversions generally involve a change from a traditional final average pay plan, where

benefits are based on workers' average pay at the end of their careers when their earnings usually are greatest, to a career average cash balance plan, where benefits are based on workers' average pay for their entire career.

In these cases, longer-service workers generally will receive less under a cash balance plan than they would have received under a traditional defined benefit plan unless the employer provides transition protections.



Pension Plan Provisions

Generally, a defined benefit pension plan requires workers to meet age and service requirements before they can participate in the plan. Workers cannot be excluded from participating because they are too old, even if they are hired within a few years of the normal retirement age specified in the plan. Usually, plans allow workers to participate if they are at least 21 years old and have completed one year of service with the company.

A year of service ordinarily is a 12-month period during which the worker has performed at least 1,000 hours of service.

Hours of service are generally defined as: hours for which the worker is paid or is entitled to be paid, including pay for vacation and sick leave; and hours for which the worker is awarded back pay.

Accruing Benefits

Generally, workers begin to earn (accrue) retirement benefits as soon as they become a participant in a defined benefit pension plan. However, they do not obtain a permanent right to the benefits (become vested) until they have worked a minimum period of time, as specified in

the plan. Workers may lose their accrued benefits if they leave their job *before* becoming vested.

Vesting

Being vested in a benefit means that a worker has completed sufficient years of service and is entitled to receive benefits accrued under the plan, whether or not the worker continues working for the company until retirement. Pension plans have one of two vesting schedules: cliff or graded vesting. Under cliff vesting, workers must be fully vested after no more than five years of service with the employer. The plan, however, could specify a shorter period of service. Workers have no vested rights until this

service is completed. Under graded vesting, the worker must be at least 20 percent vested after three years of service and receive an additional 20 percent vesting for each of the next four years, with full vesting coming no later than at the end of seven years of service.

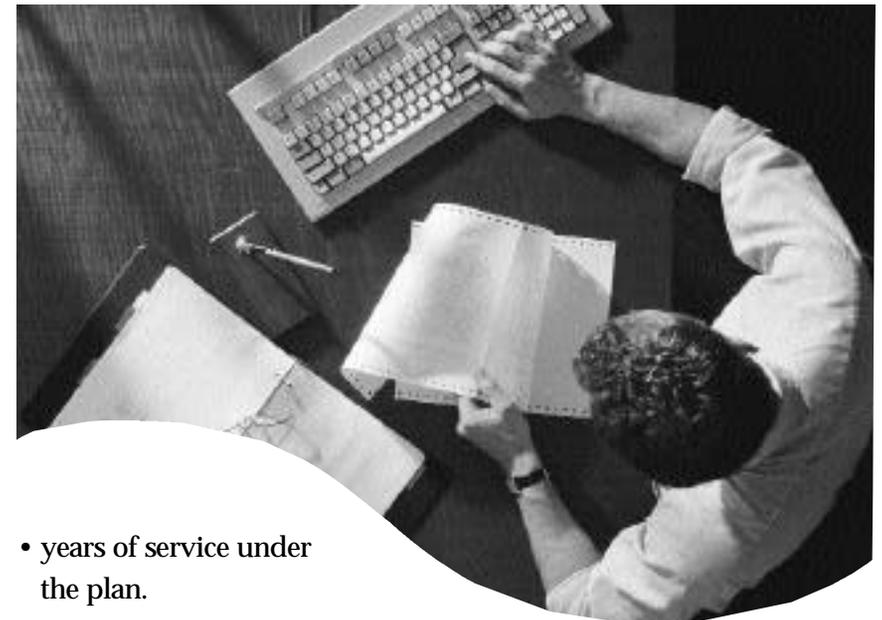
When workers leave a job in which they earned the right to a pension, their employer must provide them information about their benefits. Workers should verify the information before they leave. To be sure they receive future benefits when due, workers who change jobs should keep all the information

they receive about their pension plans and their benefits. Especially helpful are the plan's name, nine-digit Employer Identification Number (EIN) and three-digit Plan Number (PN), the name and address of the plan administrator or other plan representative, and copies of individual benefit statements. Most important, former workers should keep the plan administrator advised about any change of address or marital status.

Calculating Benefits

Defined benefit pension plans use a formula to figure the benefit amount earned. Usually, it involves salary and years of service (for example, a certain percentage of the worker's final or average salary multiplied by the number of years of service) or a flat benefit amount per year of service. The actual dollar amount will depend on such factors as:

- age at retirement;
- earnings (in plans that use salary to compute benefits);
- and



- years of service under the plan.

The longer someone works under the same defined benefit pension plan, the larger the retirement benefit.

Some plans are integrated with Social Security benefits. In these plans, the amount of pension benefits earned is reduced because of Social Security coverage.

Also, electing survivor benefits or early retirement may reduce the monthly benefit amount.

Payment of Benefits

Workers can start receiving pension benefits when they reach the normal retirement age set by their pension plan. The normal retirement age generally is no later than age 65. Workers should check their pension plans for the normal retirement age and become familiar with the other provisions of their plans. Many pension plans allow workers to take early retirement upon completing a certain number of years of service and/or reaching a given

The longer someone works under the same defined benefit pension plan, the larger the retirement benefit.

age. But if workers decide to retire early, they may receive a lower monthly benefit than they would at normal retirement age, because the benefit will be paid over a longer period of time.

Pension plans may pay benefits either as an annuity (equal payments monthly or at other regular intervals) or as a one-time payment (lump sum). If the total value of the benefit is \$5,000 or less, the plan may pay the benefit in a single sum without the worker's consent. If the benefit is worth more than \$5,000, the plan must provide the benefit as a monthly payment unless the worker (and the spouse, if the worker is married) consent to another benefit form.

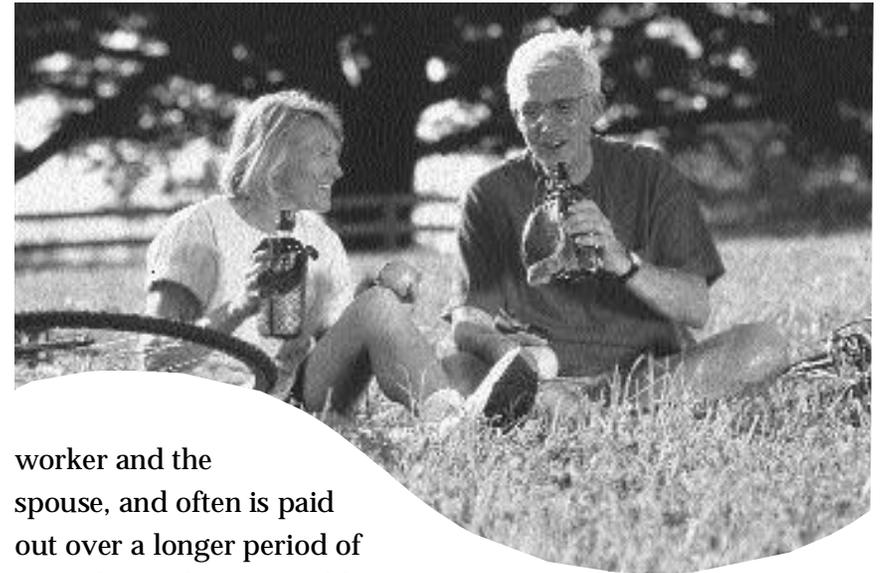
Survivor Benefits

Defined benefit pension plans normally provide survivor benefits if a worker dies either before or after retirement benefits begin. This means that if the worker is partially or fully

vested, the spouse will automatically receive survivor benefits if the worker dies — *unless the worker and spouse have specifically declined the survivor option in writing.*

If a worker dies before retirement, the plan does not have to pay the benefits to the spouse until the earliest date that the deceased worker could have begun receiving retirement benefit payments. For example, if a worker dies at age 50, and the plan says that the earliest a worker can receive benefits is at age 55, the spouse might have to wait five years to receive benefits.

If the worker dies after retiring, the surviving spouse will receive at least 50 percent of the benefits the retiree had been receiving if the worker was receiving benefits that included a survivor benefit. The benefits will continue until the spouse dies. Because this type of annuity takes into account the combined life expectancy of the



worker and the spouse, and often is paid out over a longer period of time, the worker's monthly pension payment is usually less than it would have been if the worker and the spouse had declined the survivor benefit.

Generally, pensions cannot be attached for debts owed. However, in the event of a divorce or separation, a judgment, decree, or order made in accordance with a state domestic relations law can direct the pension plan to pay a share of a worker's pension directly to a spouse, former spouse, child or other dependent. For this to occur, the order must be a Qualified Domestic Relations

Order (QDRO) — that is, it must meet legal requirements concerning the information it contains and the benefits involved.

Pension Plan Funding

Defined benefit plans usually are funded entirely by the employer. Employers generally contribute enough annually to cover the normal cost of the plan — an amount that is at least the value of the benefits that participants in the plan earned that year. In addition,

employers may have to make additional contributions for various reasons, such as to make up for any investment losses by the pension fund.

If an employer fails to make the legally required contributions, the employer can be assessed penalty taxes for each year the deficiency exists. If an employer is experiencing temporary financial hardships, the IRS may permit the employer to pay the contribution in future years under a funding waiver arrangement. Workers

must be notified each time an employer requests a funding waiver or fails to make minimum funding contributions. To protect plan benefits, in certain cases the plan may file for a lien (legal claim) against employer assets for unpaid contributions, or the employer may have to post security for a portion of the underfunding.

Pension Plan Administration

The person who administers the pension plan is known as the plan administrator. The plan administrator's responsibilities include keeping the workers fully informed of their rights and benefits, making pension payments to retirees and beneficiaries, paying insurance premiums to PBGC, and making reports to plan participants and to DOL, IRS and PBGC as required by law.

Under the law, the plan administrator must give workers the following information:

Summary Plan Description.

This document includes information on how the plan operates, when participants are eligible to receive their pensions, how participants can calculate the amount of their benefits, and how to file for their pensions. This information must be given to workers within 90 days after they become participants in the plan. The plan administrator must also notify participants about changes in the plan and, every five years, provide workers with an updated version of the summary plan description if the plan has been modified.

Summary Annual Report.

This report contains information on the financial activities of a pension plan and must be provided to workers annually.

Notice to Participants.

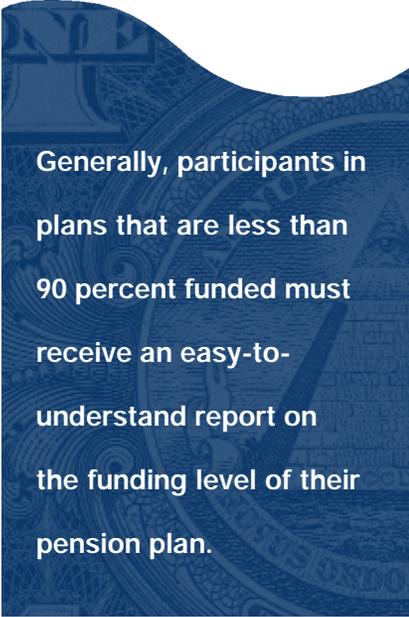
Generally, participants in plans that are less than 90 percent funded must receive an easy-to-understand notice reporting

the funding level of their pension plan, indicating how much of their pensions are currently covered by the plan assets. The notice also explains what benefits in the plan would be covered by PBGC's insurance in the event the plan terminates.

Individual Benefit Statement.

This statement, which participants may request annually and when they leave for another job, shows the benefits a participant has accrued under the plan and tells whether the participant has a vested right to receive them.

If any of the required information is not provided, workers should contact the Division of Technical Assistance and Inquiries, Pension and Welfare Benefits Administration (PWBA), U.S. Department of Labor, 200 Constitution Avenue NW, N-5625, Washington, D.C. 20210.



Generally, participants in plans that are less than 90 percent funded must receive an easy-to-understand report on the funding level of their pension plan.

Federal Insurance For Your Pension

PBGC is the federal agency that insures the pensions of American workers covered by private defined benefit pension plans.

PBGC receives no funds from general tax revenues. Operations are financed largely by premiums paid by insured pension plans (*pension insurance stays in force even if premiums are not paid*) and investment returns.

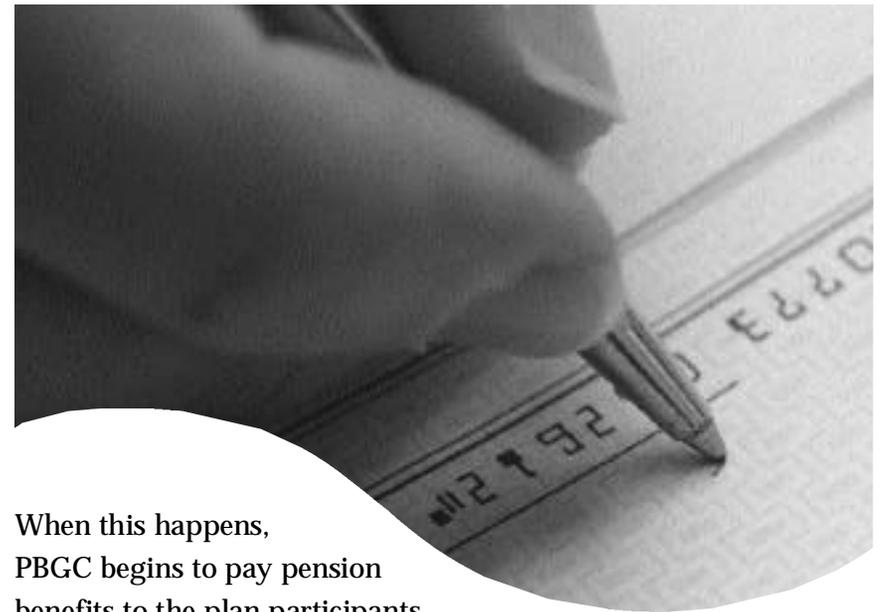
Today, PBGC insures the pensions of about 42 million workers in more than 44,000 private defined benefit plans. PBGC does not insure defined benefit plans sponsored by federal, state, and local governments. Nor does it insure some church and fraternal organization plans, professional service employer plans (such as plans for lawyers and doctors) with fewer than 25 active participants, plans maintained outside the U.S. primarily for non-resident aliens, worker compensation and unemploy-

ment insurance plans, plans that are not tax-qualified and plans not funded with employer contributions.

Two Insurance Programs

PBGC operates two insurance programs: one covers single-employer pension plans and the other covers multiemployer pension plans. The single-employer program is by far the larger, covering almost 42,000 pension plans. There are about 2,000 multiemployer pension plans.

Under the multiemployer program, PBGC provides financial assistance through loans to plans that are insolvent — unable to pay benefits (at least equal to PBGC's guaranteed benefit limit) when due. Under its single-employer program, PBGC takes over and becomes trustee of an insolvent plan when the sponsoring company can no longer support the plan.



When this happens, PBGC begins to pay pension benefits to the plan participants already receiving benefits and to others when they retire.

Pension Plan Termination

Employers voluntarily establish and maintain pension plans. They may terminate defined contribution plans at any time. But they may terminate defined benefit plans insured by PBGC only in two ways: standard termination or distress termination. In addition, PBGC may terminate a plan in certain circumstances, such as when a plan does not have sufficient assets to pay benefits when they come due.

In a standard termination, an employer may end a plan only if there is enough money to pay all pension benefits accrued by workers as of the termination date. The plan administrator will pay the promised benefits by purchasing annuities from a private insurance company or making lump-sum payments to participants. Once a plan ends in a standard termination, PBGC's insurance responsibility ends.

A distress termination involves a plan that does not have enough money to pay all pension benefits accrued by workers. A plan can end in a distress termination only if the employer meets one of the following distress criteria:

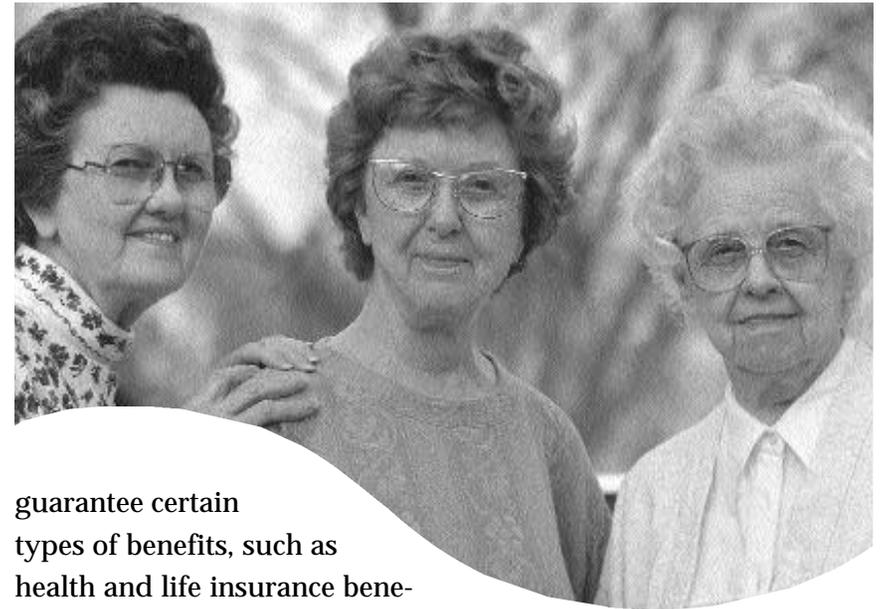
- Chapter 7 bankruptcy liquidation.
- Chapter 11 bankruptcy reorganization. The employer must demonstrate to the court that liquidation would necessarily follow if the pension plan were not terminated.
- A determination by PBGC that the employer is in such poor financial condition that unless the plan terminates the employer cannot pay its debts when due and cannot continue in business.
- A determination by PBGC that, due solely to a decline in the employer's workforce, pension costs have become unreasonably burdensome.

In a distress termination, PBGC will step in and take over the plan as trustee, and use its insurance funds to make sure the guaranteed benefits are paid to the plan participants when due.

If PBGC becomes trustee of a pension plan, it will notify all plan participants of this action. As trustee, PBGC will keep the records of plan participants and their benefits, pay benefits to retirees, and begin benefit payments to new retirees.

Insurance Coverage

Under the single-employer program, PBGC insures pension benefits provided by the pension plan up to certain limits set by law. These are benefits beginning at normal retirement age, certain early retirement and disability benefits, as well as certain benefits for survivors of deceased plan participants. PBGC does not



guarantee certain types of benefits, such as health and life insurance benefits, severance and vacation pay, death benefits, and some early retirement benefits.

The maximum benefit PBGC can pay is set by law each year under provisions of ERISA. The maximum guarantee is reduced if a worker begins receiving benefit payments before age 65 or if the pension includes a survivor benefit.

Historically, most participants in plans taken over by PBGC receive all of the benefits

they are due. Where there are reductions, they normally occur among higher-salaried workers whose benefits exceed PBGC's guarantee or in cases where benefits have been increased within five years of plan termination.

Under the multiemployer program, PBGC insures a portion of the pension earned times the worker's years of service.

Pension Checklist

If you are covered by a private defined benefit pension plan, here is a checklist for important information about your plan and your benefits that you should keep current.

- The name of my defined benefit pension plan is: _____
- The plan's EIN (Employer Identification Number) is: _____

- The plan's PN (Plan Number) is: _____
- The name of the plan administrator is: _____
- I can contact my plan administrator at: _____
- I became/will be vested in the plan on (date): _____
- Under the plan, I can take early retirement, with reduced benefits, at age: _____
- I can retire with full benefits at the normal retirement age, which is: _____
- I will reach normal retirement age on (date): _____
- My plan allows me to receive my benefits (in a lump sum and/or as an annuity in monthly installments for life, depending on the benefit value): _____
- My Social Security benefit (will/will not) _____ be deducted from my pension benefit.
- Both my spouse and I (have/have not) _____ declined in writing the joint-and-survivor option that would allow my spouse to continue receiving a portion of my benefit if I die first.
- Both my spouse and I (have/have not) _____ declined in writing the preretirement survivor annuity option that would provide a benefit to my spouse in the event I die before I retire.
- I have learned from my plan administrator which of my benefits are covered by PBGC insurance if my plan is terminated and taken over by PBGC: _____

Other Useful Publications

The PBGC publication *Your Guaranteed Pension* provides additional details about the single-employer insurance program. To obtain a copy, please write to *Your Guaranteed Pension*, No. 521E, Pueblo, CO 81009. *Your Guaranteed Pension*, as well as other pension information, is also available on PBGC's homepage at www.pbgc.gov on the Internet.

Another publication that provides useful information about pension plans is *What You Should Know About Your Pension Rights*, which is available from the Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Avenue N.W., Room N-5619, Washington, D.C. 20210. Other information is available on DOL's homepage at www.dol.gov/dol/pwba on the Internet.

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