Pensions (1949)

Simplicity in PENSIONS

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MOST EMPLOYERS, when they are considering the establishment of a pension or profit-sharing plan, want something as simple as possible. There is no reason why they cannot achieve it. Frequently, however, their plans become confused in a welter of detail resulting, in many cases, from well-intentioned but ill-informed advice. In such instances, the basic objectives tend to become lost, and the employer finds himself unable to "see the forest for the trees."

Pensions aren't that complicated! There is really no reason for getting lost in detail, particularly if the primary provisions of any pension plan are kept clearly in mind. These provisions are not so very numerous, nor are they complex.

Three Fundamental Factors

You can easily establish the basic structure of a pension plan, and largely determine its costs, by deciding just three factors. Once they are settled, the rest, if you care to go further, will follow easily. By repeated reference to these three things, you will go far towards eliminating any possible confusion.

The three main factors are—

1. ELIGIBILITY
2. THE BENEFIT FORMULA
3. RETIREMENT AGE

Let's take them up in order.

I. "Eligibility" — or When Shall an Employee Be Admitted?

An employer might say: "I'm setting up a plan to take care of people who work with me until retirement. Why take anybody into the plan until I can expect he is going to stay with me?"

There may be good reason for this question. For instance, suppose his company has 1,000 employees. His personnel officer might advise him that, judging from past experience, only 5% or 6% of the newest employees —those who had been with the company less than a year—could be expected to stay with the company until they reach age 65.

Breaking it down another way, the personnel officer might estimate that only 10% of the employees under age 25 would stay until they were 65.

"But if an employee works as much as three years," the personnel officer says, "and is at least 30 years old, it's better than an even chance that he will stay until retirement age."

Waiting Periods, Minimum Ages

This employer, therefore, might reasonably provide in the pension plan for his company that an employee must have worked three years and must have reached age 30 before admission to the plan. In that way a great many "ins" and "outs" in the membership of the plan would be eliminated.

The experience of your own personnel department may be quite different. Perhaps a one-year "waiting period" would eliminate most of the turnover. A minimum-age provision of 25 might do the same. However, you may find in your company that a waiting period would have little effect unless it were set at five years, or even longer; and even then it might have to be coupled with a fairly high minimum-age provision.

Make Every Employee Eligible?

It is true that in some types of plans there is no great expense involved in admissions and withdrawals of employees. In these plans the employer might consider admitting all employees as soon as they came with the company; it would give the employer more time to pay for their pensions and it might help morale among the newer employees. Such a plan would, of course, provide larger benefits.

Some delay in admitting the employees is usually found to be a practical necessity. In the case of each pension plan, the duration of this period should be governed by the employment experience of the company.

2. The "Benefit Formula" — or What Shall Be the Amount of the Pensions?

Benefits have to be computed according to a fixed formula. Usually the formula is based both on the employee's length of service and on the amount of compensation.

For example, a plan might provide that for each year of service as a participant of the plan, an employee would receive a credit of 1½% of the amount he earned in that year. Thus an employee who was a participant for 30 years and had an average salary of $4,000 per year would receive a pension of 45% (30 times 1½%) of $4,000, or $1,800 a year.

To prevent discrimination against older employees, it is also common to give some credit for "past service"—service rendered prior to the establishment of the plan.

This is frequently based on some formula similar to that above, but usually at a reduced rate—say, 1% of earnings for each year of service, rather than 1½%. "Earnings," for the purpose of this formula, are usually assumed to be at the employee's then annual rate, instead of the amounts actually earned in the past years.

Other Formulas

Sometimes the amount of pension is based on average earnings over the last five years of employment, rather than over the entire period. Pensions can also be based on final salary, but that is simply an exaggerated form of the final-five-year average.

In some cases plans have been written to pay a flat sum of, let us say, $100 a month, regardless of age or length of service. This clearly penalizes the employees who have worked for the company a long time.

Another method of placing greater emphasis on earnings and less on length of service is to establish a formula, for example, of 25% of final salary, regardless of how long a person has been employed, plus ¼% for each year of service.

Minimum Benefits

The last formula, through the provision of 25% of salary regardless of length of service, provides in effect a minimum benefit. In many cases, a minimum of some sort is well worth considering. Sometimes, with the best intentions in the world, plans have been set up so that some employees retire on a pittance. This is not good for the employee or the employer. A minimum pension will avoid this situation.

But the minimum amount need not be based on a percentage of earnings. More commonly a dollar amount is the basis, and it is often tied in with payments under the Social Security system. For example, a minimum pension of $50 a month would, together with an average Social Security payment, provide younger employees with a total retirement income of something like $100 a month.

The Employer Must Decide

Just as in the case of "eligibility," the "benefit formula" depends on the particular circumstances of each employer and his employees. The objective is to provide adequate and fair pensions. A pension plan which provides inadequate and unfair pensions is worse than no plan at all. By and large, a formula giving credit for both earnings and length of service, probably with a minimum pension, is most common today.

3. "Retirement Age" — or At What Age Shall Employees Retire?

In practice, this question is usually: "What shall be the *normal* retirement age?" The typical plan provides that, while ordinarily an employee shall retire at the normal retirement age, he may be kept on at the company's option or he may retire earlier (at a reduced pension) at his own option.

In most cases the normal retirement age is 65. At least, that is so for male employees. A number of plans provide for retirement of females at age 60 and males at 65. The reason for the use of age 65 is probably explained by the fact that Federal Social Security payments start at that time. Since most corporate pension plans are set up with a view to having their benefits supplemented by the Federal system, it is reasonable that the retirement age of both be correlated.

There is no reason, however, why some other age cannot be used if it seems desirable to the employer. He should keep in mind, however, that an earlier retirement age will add sharply to costs, and a later one will reduce them.

For example, if normal retirement is set at 60, two things happen: *First,* the younger a man is when he retires, the longer is his life expectancy and consequently the greater is the sum the employer must put aside to pay him a stated pension. *Second,* this greater sum must be set aside by the employer in a shorter period of years. Both of these two factors make the real cost of a pension starting at 60 considerably more than that of the same pension starting at 65. A later retirement age, of course, has a reverse effect on the cost.

Efficient Operation of a Plan

In the final analysis, the cost *of the pension plan* should not be the only consideration in determining the normal retirement age. The retirement age has a decided effect also on the company's regular payroll costs. The higher pension cost of an early retirement age will result in a lower payroll, as high-salaried employees are replaced by new employees. Conversely, later retirement means that the payroll will stay at a high level, and the saving in pension costs will be partially offset or even wiped out entirely.

You cannot, of course, treat a loyal employee as you would a piece of machinery. But the fact is that with increased age the employee, in most cases, becomes less efficient. To replace the older employees, and to permit them to retire in comfort and security, has proved to be a wise and sound practice for hundreds of employers.

Settle the Fundamentals First

These three points—"Eligibility," "Benefit Formula," and "Retirement Age,"—are the "ABC" of pensions. Everything else is built around them, and once they are decided the fundamentals of your pension plan are settled. They are the key to simplicity in pensions.

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