Pension & Profit Sharing Plan Risks

The recent Department of Labor/Treasury hearings on "Lifetime Distribution Options" within 401(k) Plans generated nearly 800 public comment letters. While opinions varied as to whether such plans should have annuity options, it did serve to point out one of the main risks of retirement plan, the longevity risk. The other main risk is the investment risk.

These risks are either borne by the plan sponsor (employer) or the plan participant (employee), depending on the type of plan. We'll discuss the sharing of these risks in the four main types of plans: the traditional defined benefit plan, the hybrid defined benefit plan (cash balance plan), the traditional profit sharing plan, and the 401(k) profit sharing plan. The first three types of plans are funded solely by the plan sponsor. In the 401(k), part of the funding comes from the participant.

LONGEVITY RISK: In the traditional defined benefit plans, this risk is borne by the plan sponsor; a monthly benefit is guaranteed, based on formulas in the plan document. If the participant receives his/her benefit as a monthly single life or joint life annuity, it continues until the participant dies, or both the participant and spouse die. The benefit can be paid from the plan assets each month, or an annuity can be purchased from an insurer. In either case, the benefit is fixed at retirement, and the cost depends on how long the participant lives (or is expected to live if an annuity is purchased). In some plans, the participant can elect a lump sum instead of an annuity, but the amount of that lump sum also depends on how long a person that age is expected to live. If longevity improves and people are expected to live longer, the amount of the lump sum is higher (as is the cost of an annuity).

In a cash balance type of defined benefit plan, the lump sum value at retirement is fixed, and the plan has set assumptions which depend on actual longevity risks to convert that fixed lump sum to a monthly benefit. The longevity risk is essentially borne by the participant.

In the two types of profit sharing plans, the amount of monthly benefit (if available) depends on the lump sum value and the price charged by an insurance company, so the participant bears the longevity risk whether benefits are taken as lump sums or annuities.

INVESTMENT RISK: This is easier. The plan sponsor bears the investment risk in both types of defined benefit plan. The participant bears it in both types of profit sharing plans. While the cash balance plan looks a lot like a profit sharing plan, having an account balance as the lump sum benefit, the interest rate credited to that account balance is determined by a fixed rate or index spelled out in the plan document. That rate is generally not the actual investment performance of plan assets, though the recently issued hybrid plan regulations may cause some plans to try to match actual plan experience.

CONCLUSION: Who bears the longevity and investment risks within pension or profit sharing plans depends on the type of plan and the provisions of that plan. In general the plan sponsor bears more of the risk in defined benefit plans, and the participant bears more of the risk in profit sharing plans.

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