Pensions can be a mystery

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Part 1

Trying to understand pensions can be like trying to understand Swahili. For those who are not immersed in the financial industry, grasping retirement pensions can be a daunting task. Regardless of how they work, the important issue is whether or not workers will have their funds available in their golden years.

Aside from the fear of public speaking, one of the biggest fears people possess is the fear of the unknown. It is difficult to feel at ease with something not understood. While no one is guaranteed tomorrow, that is no excuse not to look forward to the future. In an attempt to clarify and simplify the issue of pensions, below are some very fundamental concepts.

Then vs. Now: Social Security was born in 1935. By 1950 retirees lived off their pensions for an average of 11.5 years. In 2000 that average was extended to 18.1 years. Workers are now retiring earlier and living longer. It’s easy to see how those added years could put a strain on the nation’s entire senior support system.

One of the root causes of the pension woes is that the defined-benefit pension is an employee benefit that was designed for a different economic era. It pierced the majority of businesses after WWII, when countless workers, including the finest young recruits, were looking for a top employer to settle in with for a lifelong career.

The term “life long career” is an oxymoron by today’s standards. In August 2006, the Bureau of Labor Statistics examined the number of jobs that people born in the years 1957 to 1964 held from age 18 to age 40. On average, men held 10.7 jobs and women held 10.3 jobs.

The original pension plan is archaic. Today it’s virtually impossible to open a newspaper or turn on the television without hearing some political debate over the impending demise of economies unless there is a drastic pension reform. Many companies now have an older workforce, which means pension benefits will begin sooner. If their pension plans are under funded and the company has to make considerable payments to them, that company is at an elevated risk of bankruptcy.

That in the most rudimentary terms explains the why of the current pension tribulations. It is also important to understand a few key acronyms and terms. Otherwise it will be like attempting algebra without understanding arithmetic.

The first two are ERISA and PBGC. In 1974 Congress passed the Employee Retirement Income Security Act (ERISA). President Ford signed the legislation, which created the Pension Benefit Guaranty Corporation (PBGC), guaranteeing workers' benefits in private pension plans. Additionally, the law also required that pension plan assets must cover liabilities. Congress positioned PBGC to be a last report in the event assets weren't covered. Since ERISA began in 1974, more than 160,000 companies have willingly stopped honoring their pensions; thusly the PBGC is taking a pounding in the existing recession.

Another term to be familiar with is 'defined benefit plan.' Under a defined benefit plan, a worker is pledged a retirement benefit based on a percentage of salary for each year worked. Many government employers call this the "high three," meaning out of all the years worked, the worker's pension benefit will be based on the three years' highest salary.

'Discount rate' is one more term to know. The funding of a defined benefit pension plan is measured using a discount rate. The discount (or interest) rate used to gauge the plan's funding is crucial. The discount rate is set up to calculate whether or not the plan has adequate assets to meet its commitments over a long period of time. The discount rate has no tangible connection to how much a pension plan's investments are earning.

Whether planning to retire in 25 years or five years, your best defense is an aggressive offense. There is a great deal more to understand than the few basics mentioned above. Unfortunately the pot of gold at the end of the current pension crisis won't be found in the near future.

However, now is definitely the time to launch your own pension crisis prevention plan. Don't wait to receive the unfortunate news that there are no funds available to last the rest of your life. Due diligence is needed when determining who will manage your hard earned dollars.

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