Designing the Right Retirement Plan For Your Organization

A WHITE PAPER BY

Pentegra Retirement Services
2 Enterprise Drive, Suite 408
Shelton, CT 06484-4694
800.872.3473 tel 203.925.0674 fax
www.pentegra.com

PENTEGRA

Your Benefits Philosophy

The maturity of your business, the demographics of your workforce, the level of competition you face, and your organization's cost and benefit objectives all influence the decision as to which retirement plans make the most sense for an organization.

Retirement plans represent a large expense that employers incur to attract, retain, and motivate employees. Designing an effective retirement program means not only developing a plan that assists employees in meeting their retirement goals, but also addressing your organization's business needs.

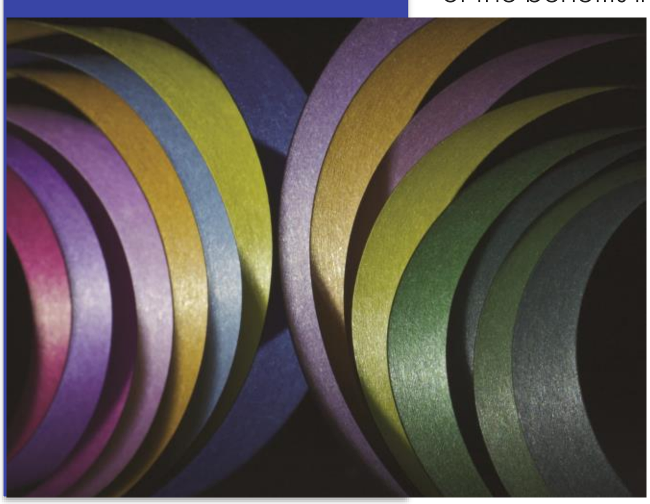
Designing an effective retirement program for your organization starts with a review of your management philosophy, compensation strategy, the different types of plans available, an analysis of what your peers offer, and considerations such as demographics and the maturity of your institution.

The challenge of designing a successful retirement program may be different depending on whether or not you are a stock institution or mutual institution. Stock institutions will typically integrate company stock with retirement plans. Mutual institutions, without the ability to offer company stock-based capital accumulation programs, will generally provide somewhat richer defined benefit and 401(k) plans.

In the final analysis, however, all financial institutions share a similar goal—to attract and retain valuable employees in order to provide a high level of customer service and to enhance the growth and profitability of the institution.

Designing a retirement program that accomplishes these goals begins with understanding an organization's business objectives and how those objectives translate into a benefits philosophy. There are two basic approaches that a company should consider in developing a benefits philosophy.

The first centers on an "Objective" Approach—that compensation and benefits are offered in order to fulfill a specific function, (i.e., to provide employees with sufficient retirement benefits). The adequacy of the benefits involves an analysis of what level of compensation and benefits allow an employee to maintain a certain standard of living.



The other is a "Competitive" approach—that attractive benefits and compensation packages are offered in order to attract and retain employees. Benefit programs should be viewed as an important component of total compensation. Adequacy of total compensation involves an analysis of wages and the level of benefits offered by competitors.

It is important to recognize that while these two approaches are different, they are not exclusive. The successful benefits program will reflect a blend of both philosophies.

The Objective Approach

How Much Do Employees Need?

The objective approach involves examining the level of income needed in order to retire comfortably. We use replacement ratios as a tool in determining how much income a retirement program should provide when viewing these programs from an objective perspective. A replacement ratio is the percentage of gross pay prior to retirement that one needs after retirement to maintain the pre-retirement standard of living. It takes into consideration the fact that the post-retirement standard of living will reflect lower taxes and other fixed costs.

Experts recommend that employees retiring in the next few years will need between 70% and 90% of their pre-retirement income to maintain a similar standard of living in retirement. These factors take into consideration the fact that post-retirement standards of living reflect lower taxes and other fixed costs. However, they do not take into consideration the impact of inflation on purchasing power after retirement. The table below illustrates how this percentage varies, based on pre-retirement income.

Annual Pay Before Retirement	Replacement Ratio
$15,000	82%
20,000	76%
30,000	72%
50,000	72%
70,000	75%
90,000	83%

Understanding Replacement Ratios

Retirement income comes from three basic sources: Social Security, an employer-sponsored retirement plan, and personal savings.

Social Security's Role

Social Security was never intended to be the total source of retirement income — but rather a safety net. The age to qualify for benefits will increase as younger employees will not be eligible to receive full benefits until age 70. Annual cost-of-living adjustments may be curtailed in the future as Congress struggles with budget deficits and the anticipated Social Security shortfall which will occur as the wave of baby boomers exhausts current reserves — by the year 2015. While an employee (married, non-working spouse) retiring at age 65, currently earning $20,000 can expect nearly 68% of final salary from Social Security (Primary plus spousal benefit), higher salaried employees have a gap of over 60% to meet the study's recommended replacement goal.

Employer-Sponsored Retirement Plans—How Much and From What Source?

The next level of protection is generally provided by the employer's plan or plans. The level of income replacement from employer plans is dependent on variables including the employee's salary, length of service, retirement age, and the employer's plan type/formula/match etc.

Defined benefit plans might be structured to provide from 30% to 40% of the total replacement income needed, depending on the employer's benefit and cost objectives. This type of plan usually provides an annuity at retirement.

Defined contribution plans are a potential, but less certain source of the replacement ratio mix. Plan structure, employee investment savvy and length of time in the plan are all factors which must be taken into consideration in determining how much income the plan will provide. Typically, these plans provide between 10% to 30% of replacement income. Unfortunately, studies show that more than 30% of lump sum distributions from these types of plans are spent well before retirement.

Employee savings are an unpredictable source of security, as savings may be a significant source of income for some and non-existent source for others. The rate of personal savings in America is fairly low — currently just below 4%. It is unrealistic to expect that lower salaried employees will have significant savings outside of any employer-sponsored savings plan to rely on at retirement.

The Competitive Approach

In order to remain competitive in today's business environment, an organization must also analyze the level of benefits it provides in relation to its peer group. The basis for providing a competitive benefit program for a financial institution is twofold. In order to attract talented personnel, it must offer both adequate and attractive benefit plans in relation to its peers. While some turnover is unavoidable, financial institutions that provide competitive benefit plans will generally experience lower turnover among middle and upper management positions within their institutions. While the cost of providing such a benefit program can be high, the cost associated with turnover or failure to attract and hire the professionals you need to run your business can be substantial. In order to retain middle and upper level managers and offset turnover in lower management positions, a financial institutions can consider a number of benefit plan options.

Compensation Strategies

Compensation has a direct link to the retirement benefits you offer employees. It is critical to developing an effective retirement program—if your compensation strategies are not competitive, your retirement program won't be competitive.

Salary

In order to implement an attractive compensation program, salary must be competitive with what other institutions of similar size and structure are offering. In determining the appropriate amount of base pay for employees at all levels, comparisons of averages are used from peer group comparisons. Usually, midpoint salary ranges are used as a starting point, and individual performance and experience is used to reach an effective point of compensation. Typically, you would perform an analysis based on institutions comparable in size (assets and employees) in a specific geographic area. Increases in salary can have a dramatic effect on retirement program costs, depending on the type of programs offered, and the demographics of your institutions.

Types of Programs To Consider

There are two broad categories of retirement programs—defined benefit plans and defined contribution plans. Each plan has its own inherent advantages and disadvantages for both employees and employers.

Defined Benefit Plans

Traditionally, savings institutions have offered defined benefit programs. Defined Benefit pension plans offer a guaranteed lifetime benefit. They provide definitely determinable benefits based on a formula that takes the employee's salary and service into consideration. Traditional defined benefit plans are designed to benefit career employees. Benefits accumulated in the early years of an employee's career are minimal; however, they accelerate more rapidly as an employee reaches retirement. At retirement, benefits can be paid over a lifetime of the retiree, and the lifetime of the spouse, if elected. The employer assumes the investment risk under a defined benefit plan. The plan's benefit formula guarantees a certain level of benefit, and the employer bears the investment risk if plan assets are inadequate to fund this level of benefits. Conversely, pension costs are offset by favorable investment performance, among other things. If returns are favorable, the employer's costs are reduced, and in some cases, even eliminated for a period of time.

Cash Balance Plans

While traditional defined benefit plans have been favored by many mutual institutions, changing employee demographics have seen an increase in the number of financial institutions that convert from a traditional defined benefit program to the cash balance plan. Cash balance plans are a type of hybrid defined benefit plan. They provide the benefit protection and security of a traditional defined benefit plan. Benefits are expressed in the form of an account balance. Although cash balance plans can be started as a new plan, most are established by amending an existing defined benefit plan. Initial account balances can be derived from the value of an employee's accrued benefit as of the transition date under the existing defined benefit program. The lump sum benefit at retirement is based on an accumulation of annual allocations, expressed as a percentage of pay, plus interest credited at a guaranteed rate annually. Benefits at termination are completely portable, enabling employees to "rollover" their account to a new employer's plan or to an IRA. This portability feature is one of the elements that make cash balance plans similar to defined contribution plans.

Defined Contribution Plans

Defined contribution plans, such as 401(k) and profit sharing plans are account accumulation plans. Benefits at retirement are based on the size of the individual's account. Because individual account balances are expressed in dollars and cents, rather than benefit formulas, employees can, at any point in time, definitively determine the value of their account. The complexity arises in determining the level of benefit that the account value will provide at retirement.

401(k) Plans

The most well-known and widely offered defined contribution plans are 401(k) programs. 401(k) plans offer two major incentives—a tax shelter and often, employer matching contributions. Under a 401(k) plan, the employee usually saves a portion (up to 15%) of his or her salary on either a pretax or after-tax basis through payroll deduction. Typically, the employer makes a matching contribution to provide an incentive for employees to contribute to the plan. Employee and employer matching contributions and earnings accumulate tax-deferred. The employee has full investment discretion, and assumes full responsibility for those investments. The plan provides an easy way for the employer and the employee to share in the responsibility of savings for retirement.

Profit Sharing Plans

Under a profit sharing plan, employer contributions are discretionary. Contributions to a profit sharing plan are usually keyed to the existence of company profits—although actual profits are not required for a company to make a contribution. Contributions are then allocated to participant accounts according to the plan's allocation formula. At retirement, benefits are based on the value of a participant's account.

Executive Benefit and Director Plans

Executive benefit plans reward a select group of employees without impacting costs on an employee-wide basis. Executive benefit plans can be used to replace benefits lost due to IRS limits on qualified plans, provide benefits in addition to those provided under qualified plans, as well as to defer compensation. These plans can also be used to provide enhanced benefits in the event of a change in control. While these plans are designed to cover only your key employees, they are an integral part of any compensation program. In today's marketplace, the most sought after executive benefit arrangements include:

Benefit Equalization Plans

An executive benefit program for key employees designed to replace qualified plan benefits lost as a result of IRS limitations on salary and benefits.

Supplemental Executive Retirement Plans

An executive benefit program designed to reward officers and/or commissioned salespeople. Plans may be entirely discretionary and designed to provide rewards arbitrarily or based on specific performance factors. Benefits provided through these arrangements are over and above those provided by qualified plans.

Deferred Compensation Arrangements

Deferred compensation arrangements permit designated executives to defer additional compensation to avoid current taxation. These plans are typically established in order to provide a vehicle for key employees, highly compensated employees and Directors to defer compensation until retirement.

457(b) PLANS

Similar to deferred compensation arrangements, 457(b) plans are deferred compensation plans for employees of local and state governments and tax-exempt organizations. These plans are typically established in order to provide a vehicle for key employees, highly compensated employees and Directors to defer compensation until retirement, when taxes may be lower.

457(f) PLANS

A 457(f) plan is a non-qualified retirement plan which gives the tax-exempt employer an opportunity to supplement the retirement income of its select management group or highly compensated employees by contributing to a plan that will be paid to the executive at retirement.

Demographic Considerations

In designing the right retirement program for your organization, many factors have to be considered. These issues include appropriate benefit levels, benefit limitations, deductibility of contributions, cost issues, employee demographics and competitive issues. Increasingly, organizations today sponsor more than one type of retirement program, as different types of plans meet different goals and provide varying levels of retirement income. A combination of plans often results in a retirement program that better meets the needs of both the employer and employees.

The Demographics of Your Organization

What type is most cost-effective for your group? Demographics play a significant role in determining the type of program that will be most effective for your organization. Employees come in different ages, situations, and salary levels. Is your workforce made up of employees that are under 35 or over 40? What kind of turnover do you experience? Do you want to reward long-service employees, or attract younger employees? Different plans provide different types of benefits to different types of employees. And employees have different expectations about retirement security. To maximize your benefit dollars, you need to consider the demographics of your employee group.

Younger Employees vs. Older Employees

Defined benefit plans can be more advantageous to older employees if they have established their career at your institution. Defined contribution plans, such as 401(k) plans, tend to be more advantageous to younger employees. Younger employees have the benefit of time—time over which their savings can grow, tax deferred, with the added effect of compounding. Generally speaking, these plans are less advantageous to older employees because they have fewer years over which to accumulate savings for retirement, and fewer years for those savings to grow. But younger employees appreciate the increased control, flexibility, and access to funds that a 401(k) plan provides.

Cash balance plans may also provide an attractive plan design because they allocate benefits more equitably among younger and older employees. That is because dollars contributed early in an employee's career have the most significant impact as a result of compounding of interest.

Career Employees vs. Mobile Employees

Generally, traditional defined benefit plans pay the most generous benefits to long-service employees who spend their career dedicated to working for the organization. Career employees want to be rewarded for their commitment to the organization, and sponsoring a traditional defined benefit plan is an effective way to accomplish this goal.

For the short-term employee, on the other hand, defined benefit plans provide minimal benefits. That's because real benefits start to accrue after a number of years of service with the organization. Defined contribution plans, such as 401(k) and Profit Sharing Plans, provide more immediate and visible benefits for this type of employee. These plans also offer portability—employees may take their account with them when they leave the company and place the distribution in an Individual Retirement Account or their new employer's defined contribution plan.

Benefit Limitations

In order to design the appropriate retirement program, however, the employer must pay special attention to benefit limitations and tax deductibility limits. The IRS has various rules and regulations that govern these issues which must be complied with. When discussing IRS benefit limitations, several limitations come into play. Internal Revenue Code (IRC) Section 401(a)(17) limits the amount of compensation that may be used to determine benefits and contributions under any type of qualified plan. The current annual compensation limit is $245,000. In addition to the maximum compensation limit, there are maximum benefit limits which impact both defined benefit plans and defined contribution plans like 401(k) programs. Section 415 of the Internal Revenue Code specifies that the maximum annual benefit that an employee may receive under a defined benefit plan at age 65, is limited to $195,000 at ages 62-65 in 2010. In the case of early retirement, this limit may be significantly lower. The IRS also limits the annual amount of contributions that can be made to an employee's account under a defined contribution plan to the lesser of $49,000 or 100% of compensation.

If more than one defined contribution plan exists, such as a 401(k) and Profit Sharing Plan, these plans are generally combined for maximum benefit limitations.

Since it is more likely that a highly compensated employee is impacted by these IRS limitations, often a nonqualified plan is developed to supplement the qualified plan benefits.

Tax Deductibility Limits

The IRS also has rules governing tax deductibility limits which are detailed in IRC Section 404. These deduction limits may impact employers maintaining more than one retirement program. The IRS has set specific limits on the maximum amount that may be deducted for each type of plan. Employers maintaining a defined benefit plan may generally deduct the normal cost of the plan plus the amount needed to amortize any unfunded liabilities over 10 years. The plan's normal cost is defined as the cost to fund the current year's benefit accruals. However, if the plan assets exceed liabilities, the employer's required contribution (and the IRS deductible contribution) is reduced or even eliminated.

Defined contribution plans are also subject to overall combined deductibility limits. 401(k) and profit sharing plans are subject to a maximum deduction of 25% of total annual W-2 compensation (exclusive of elective deferrals to 401(k) and Section 125 plans) for eligible employees.

Where an employer maintains more than one defined contribution plan, the IRS limits the tax deductibility of contributions by treating all defined contribution plans as a single plan. Where both a defined benefit and a defined contribution plan are in place, the IRS generally limits the tax deductibility of total contributions to these plans to 25% of the total W-2 compensation of all eligible employees.

One question that may arise in discussing deductibility is, "What happens if a non-deductible contribution is made?" In the event that a non-deductible contribution is made, an employer must pay an annual 10% federal excise tax on the non-deductible portion until the contribution either becomes deductible in a later year or is returned to the employer.

In addition to taking maximum benefit limits and deductibility limits into consideration in designing your retirement program, cost constraints are also a major consideration. While our experience has indicated that an employer's overall retirement costs, exclusive of social security, are often in the range of 10-15% of compensation, this does vary widely, especially when the organization is a stock institution. Some additional statistics from Pentegra's client base may help add perspective to the cost issue. For example, our mutual institutions spent, on average, 9.3 percent of covered payroll for a defined benefit plan. Our stock institution clients have an average cost of 7.8 percent for defined benefit plans. More importantly, 31 percent of our mutual institutions have an average cost over 10 percent of payroll, while only 16 percent of stock institutions do. Obviously, without other stock based capital accumulation plans, mutual institutions provide greater benefits under their defined benefit plan than stock institutions. In addition, the average employer contribution to a 401(k) plan among financial institutions was 3 percent of payroll.

Defined benefit plans can be structured with a cost as low as 4-5% of payroll and rarely exceed 15% of payroll. 401(k) plans and profit sharing plans can range from no employer cost (other than administrative cost) to as high as 25% of payroll. While plan sponsors remain concerned about the cost of maintaining their retirement benefit programs, our experience over the last year has focused on reviewing plan design in order to reduce cost and volatility of contributions and expense. Our sense from consulting with our defined benefit clients is that they are sensitive to any benefit reductions at a time when employees have just begun to recover from the effects of recent market volatility on 401(k) accounts.

In the case of any plan redesign, employers must clearly understand the effects a restructured program would have on their employees—particularly long-term employees—on an individual basis, yet continue balance the needs of younger employees, who typically prefer more portable defined contribution plans. Pentegra's experience in working with financial institutions affords the advantage of peer comparisons and statistical benchmarking of financial institutions in helping you evaluate your retirement program.

As a provider dedicated to serving financial institutions, Pentegra offers the benefit of 65+ years of insight in developing retirement programs that address your unique concerns. Those insights lead to an informed dialogue about the best way to build a retirement plan that meets both benefit and cost objectives, and helps you focus on attracting and retaining the employees needed to make your organization a success.

For more information on plan design considerations, contact us at www.pentegra.com or 800.872.3473.

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