The Bulletin:

Milliman

This chapter of The Bulletin explores how multiple benefits offered by an employer as part of total retirement income planning can lend itself to ***benefit adequacy***.

Total retirement income

Most employees in the workforce have some level of retirement benefits provided by the employer and/or the employee. Employees of a church organization generally have four sources of retirement income, as illustrated in Figure 1. We will examine in more detail the first two sources in this chapter and recommend the Milliman RISE Score™ for overall examination of personal benefit adequacy:

- Pension plan benefits
- 403(b) plan benefits
- Personal savings and investments
- Social Security benefits

"Defined benefit pension plan" definition

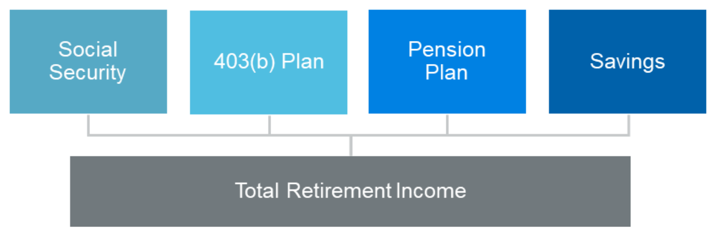
Defined benefit (DB) pension plans, or, more simply, pension plans, provide employees with a guaranteed annuity when they retire. As the plan sponsor, the church will often fund the full cost of the promised benefit and invest the funds in a trust fund that is protected under federal regulations. The benefit is typically based on a fixed dollar amount for each year of service or based on salary and total years of service.

"403(b) benefit plan" definition

A 403(b) benefit plan is available to specific employees of tax-exempt organizations. These plans are "defined contribution (DC)" plans that are based on employees making pretax (and sometimes post-tax) contributions into 1) a tax-sheltered deferred annuity from an insurance company, 2) a custodial account at a brokerage invested in mutual funds, or 3) an account that allows the employee to invest in either of these options. The 403(b) may also have an employer match.

The features of a 403(b) plan are comparable to those found in a 401(k) plan sponsored by for-profit organizations. The primary similarity to 401(k) plans is that the contribution limits for a 403(b) plan are identical to those of 401(k) plans. Employees defer portions of their income on a pretax basis and reduce the participant's adjusted gross income (AGI) for income tax purposes. These plan types have additional similarities and differences that we will not review in this chapter of The Bulletin.

FIGURE 1: SOURCES OF RETIREMENT INCOME



How are pension plan benefits determined?

We assume the pension plan benefit will be payable for a participant's lifetime as a monthly annuity starting at age 65. Other annuity options are available, and a single sum may be available. We will explore these other annuity and lump sum options in another chapter of The Bulletin.

Suppose a participant's pension plan benefit will be 1% of the final year salary multiplied by the number of years of service with the church. Assume the following:

- Hired at age 25 with a starting salary of $40,000
- Receives salary increases of 2% per year
- Retires at age 65

The final year salary at age 65 will be about $87,000 after applying 2% increases for 40 years from the starting salary. The final benefit will be 1% of $87,000 multiplied by 40 years of service, which is about $34,800 per year. The pension benefit will provide the participant with 40% of the final year salary, or $2,900 per month payable for the participant's lifetime.

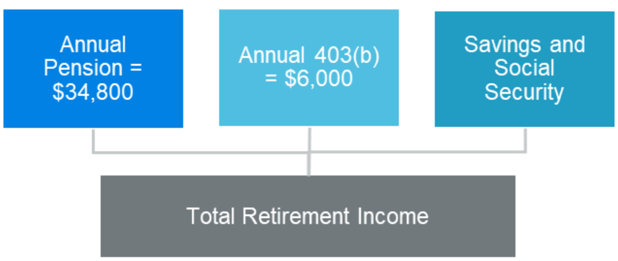
Determining the 403(b) plan benefit

A 403(b) plan benefit is a custodial account plan invested in mutual funds. The final 403(b) benefit will be based how much a participant decides to contribute, how much their employer matches, and the investment returns earned by the invested mutual funds. In addition to the details above, let us assume the following relating to the 403(b) plan:

- Employee contributes 1% of annual salary
- Selected mutual funds earn 6% per year

The growth in the custodial account as of age 65 will be about $80,000. To compare with the pension plan benefit, we convert the account balance into an annuity payable for the participant's lifetime. In this example, the conversion factor is 15.8.[1] The corresponding annuity value will equal about $6,000 per year based on $80,000 divided by 15.8. The 403(b) benefit will provide the participant with about 6% of the final year salary, or $420 per month payable for the participant's lifetime.

FIGURE 2: TOTAL RETIREMENT INCOME



Are the pension and 403(b) benefits adequate?

Based on the assumptions and results discussed above, the participant's pension and 403(b) plans will provide about 46% of final year pay or $39,800 per year as shown in Figure 2. Benefit adequacy depends on many personal factors that the participant will need to consider, including:

- Retirement age. *Will the participant delay retirement past the typical age 65? At what age is the participant's spouse planning to retire?*
- Lifestyle after retirement. *Will the participant want to add activities such as travel?*
- Continuing in the workforce. *Will the participant decide to take a part-time job while in retirement?*
- Health status. *Will the participant need additional health coverage due to any preexisting conditions?*
- Limiting recurring expenses. *Is the participant still making mortgage payments or are there any other recurring expenses to consider?*
- Other sources of income. *Will the participant have other savings and Social Security benefits to consider for retirement? Is a HELOC or reverse mortgage an option for supplemental retirement income?*

Various published studies indicate that employees should target between 70% to 85% replacement of preretirement income. Based on these publications, the participant in our example would need have a replacement ratio between $61,000 and $74,000 per year.

Milliman RISE Score™

Milliman has developed a simplified planning tool, the Retirement Income Security Evaluation (RISE) Score™, to help financial planners and their clients with retirement planning. The RISE Score™ provides a rating similar to a credit score to which most people are familiar when applying for a loan. In creating their personal RISE Score, individuals can consider the various personal factors to help determine a replacement ratio that will provide *benefit adequacy* for retirement.

Your Milliman actuary

This Bulletin chapter brought to you by Delbert Zamora, Principal and Consultant Actuary.

Milliman

For more information about The Bulletin series, see prior articles here.

Do you have a question about your defined benefit pension plan? Write to us at thebulletin@milliman.com.

[1] Annuity conversion is based on mortality and interest rate. For the example in Figure 2, we use RP2006 mortality with MP2020 generational scale factors and a 3.5% interest rate.