Early Retirement Provisions in Defined Benefit Pension Plans

BY ANN C. FOSTER

Most workers participating in defined benefit pension plans had provisions for early retirement. The greatest proportion of these workers were in plans with variable early retirement reduction factors.

Workers, especially men, have been retiring earlier in recent years. This is shown by the steep decline in the labor force participation rates of men 55 and over. In 1970, 83 percent of men age 55 to 64 were in the labor force, but by 1995 this rate had decreased to 66 percent. Among women age 55 to 64, however, the participation rate grew somewhat, from 43 percent in 1970 to 49 percent in 1995. Among those age 65 and over, 27 percent of men and 10 percent of women were in the labor force in 1970; by 1995, participation rates had dropped to 17 percent for men and 9 percent for women.[1]

This article focuses on early retirement provisions in defined benefit pension plans for full-time workers in medium and large private establishments (those employing 100 workers or more) and State and local governments. These private establishments are comparable in size to most State and local governments. The data used are from the 1993 and 1994 Employee Benefits Survey (EBS) which studies the incidence and characteristics of employer-provided benefits.[2] Early retirement requirements, reductions, and supplements form the core discussion of the article.[3]

Background

Defined benefit pension plan incentives are one factor influencing the early retirement trend. Most workers participating in defined benefit pension plans can retire before the normal retirement age and receive a reduced pension.[4] Data from the 1993-94 Employee Benefits Survey show that among workers with defined benefit coverage, 95 percent of those in medium and large private establishments and 87 percent of those in State and local governments participated in plans with early retirement provisions.

While early retirement is prevalent, specific plan provisions vary between the public and private sectors. The Employee Retirement Income Security Act of 1974 (ERISA) sets minimum standards for pension plans in private industry. It does not, however, require pension plans to provide early retirement benefits. Private plans can establish their own eligibility criteria. Nevertheless, ERISA does require that early retirement benefits be at least the actuarial equivalent of a plan's normal retirement benefits.[5]

In contrast, State and local government plans are not regulated by ERISA. Although many attempts have been made to bring them under Federal jurisdiction, these plans are regulated only by individual States and local governments.[6]

Early retirement requirements

The most common early retirement requirements are age and length of service. Almost 3 out of 4 private sector workers were in plans permitting early retirement at age 55. Table 1 shows early retirement eligibility requirements for full-time workers in defined benefit plans with such provisions.

The greatest proportion of private employees (34 percent) were in plans permitting early retirement at age 55 with 10 years of service, but substantial proportions were in plans permitting early retirement at age 55 with 5 years of service (21 percent) and age 55 with 15 years of service (13 percent).

The most common age and service requirements for public workers were age 55 and 5 years of service (12 percent), age 55 and 25 years of service (10 percent), and age 55 and 10 years of service (9

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Table 1. Requirements for early retirement, full-time employees by establishment type, 1993-94

(In percent)

Requirement	Medium and large private establishments	State and local governments
Total with early retirement provision	100	100
Less than age 55	9	20
No service requirement	(1)	-
Service requirement		
5 years	1	8
6-9 years	(1)	(1)
10 years	2	1
15 years	1	1
20 years	1	5
25 years	2	1
30 years	(1)	3
Age 55	72	46
No service requirement	2	-
Service requirement		
Less than 5 years	1	3
5 years	21	12
6-9 years	(1)	1
10 years	34	9
11-14 years	(1)	-
15 years	13	5
20 years	2	3
25 years	(1)	10
30 years	-	2
Age 56-59	1	-
No service requirement	(1)	-
Service requirement		
10 years	(1)	-
15 years	(1)	-
20 years	(1)	-
25 years	(1)	-
30 years	1	-
Age 60	7	3
No service requirement	(1)	-
Service requirement		
5 years	2	(1)
10 years	3	1
15 years	1	-
20 years	(1)	2
Age 62	3	(1)
No service requirement	(1)	-
Service requirement		
5 years	(1)	-
10 years	2	(1)
More than 30 years	(1)	-
Service requirement only	5	26
Less than 30 years	(1)	16
30 years	4	9
More than 30 years	(1)	(1)
Sum of age plus service	3	3
Less than 80	2	3
More than 80	1	(1)

[1] Less than 0.5 percent.

NOTE: Because of rounding, sums of individual items may not equal totals. Dash indicates no employees in this category.

Table 2. Early retirement reduction, full-time employees by establishment type, 1993-94

(in percent)

Early retirement reduction	Medium and large private establishments	State and local governments
Total with early retirement available	100	100
Uniform percentage reduction	36	39
Less than 3.0	2	3
3.0	4	9
3.1-3.9	1	(1)
4.0	5	1
4.1-4.9	1	4
5.0	8	11
5.1-5.9	(1)	-
6.0	11	9
6.1-6.9	2	(1)
7.0	(1)	(1)
Greater than 7.0	(1)	1
Reduction varies	64	60
By age	54	55
Reduction differs each year	28	35
Reduction differs by age bracket	26	20
By service	10	4
Other reduction	(1)	2
Average uniform percentage reduction[2]	4.8	4.6

[1] Less than 0.5 percent.

[2] For all covered workers; averages exclude workers in plans without uniform percentage reduction provisions.

NOTE: Because of rounding, sums of individual items may not equal totals. Dash indicates no employees in category.

percent). Twenty percent of State and local government employees could retire before age 55 with varying lengths of service compared to 9 percent of private employees.

Public employees were more apt to participate in plans with a "service requirement only" than were private employees. Twenty-six percent of State and local government employees participated in such plans, compared to 5 percent of employees in medium and large private establishments. Regardless of sector, almost all of these employees were in plans with service requirements of 30 years or less.

Under some plans, workers could retire early if their age and years of service equal a specified sum, such as 75 or 80. Such plans usually require an employee to be a specified age. For example, a plan may allow an employee, who is at least age 55, an early retirement option if the sum of the employee's age and length of service equals or exceeds 80. This means that a 60-year-old employee with 20 years of service would be eligible for early retirement. In 1993-94, few workers participated in plans with these requirements.[7]

Early retirement benefits

A worker who takes early retirement will receive benefits over a longer time period than if benefits had begun at the normal retirement age. This is why, all factors being equal, such a worker usually receives a smaller pension than one who retires at the normal retirement age. Early retirement benefits are generally based on the normal retirement benefit to which a reduction factor is applied.

Uniform percentage reduction. Some plans have a uniform percentage reduction for each year between the actual and the normal retirement ages. For example, a plan has a normal retirement age of 65 and an early retirement reduction factor of 5 percent for each year below normal retirement. A person retiring at age 61 would receive 80 percent [100 percent - (4 years x 5 percent)] of the normal benefit.[8]

A uniform percentage reduction factor was used in plans covering approximately 36 percent of private employees and 39 percent of public employees in plans with early retirement provisions. (See table 2.) Of those employees subject to this factor, nearly two-thirds faced benefit reductions smaller than 6 percent per year. Six percent is often considered a roughly actuarially neutral early retirement reduction factor. This indicates that employers using reduction factors of less than 6 percent are subsidizing some of their employees'early retirement benefits.[9]

Reduction varies by age. The greatest proportion of employees

Exhibit 1. Early retirement reduction differing by life expectancy at age of retirement

Retirement age	Replacement rate	Annual benefit	Percent of normal benefit	Average reduction per year (percent)
55	10.42	$3,126	39.90	6.01
56	12.03	3,609	46.09	5.99
57	13.64	4,092	52.24	5.97
58	15.24	4,572	58.35	5.95
59	16.84	5,052	64.49	5.92
60	18.42	5,526	70.55	5.89
61	20.00	6,000	76.60	5.85
62	21.56	6,468	82.57	5.81
63	23.11	6,932	88.50	5.75
64	24.62	7,386	94.30	5.70
65	26.11	7,833	100.00	0.00

Exhibit 2. Early retirement reduction differing by age bracket

Retirement age	Percent reduction	Annual benefit	Percent of normal benefit
65	0	$6,000	100
64	3	5,820	97
63	3	5,640	94
62	3	5,460	91
61	3	5,280	88
60	3	5,100	85
59	5	4,800	80
58	5	4,500	75
57	5	4,200	70
56	5	3,900	65
55	5	3,600	60

were in plans with variable reduction factors. The most frequent variation was according to age. One common form is the actuarial method which is based on the employee's life expectancy at the age early retirement is taken. This type of reduction was applicable to 28 percent of private employees and 35 percent of public employees with early retirement provisions.

An example of a reduction schedule varying by age at time of retirement is shown in exhibit 1. It is assumed that employees will receive a normal retirement benefit at age 65 if they have at least 10 years of service. Employees with 10 years of service can, however, opt for early retirement at age 55.

If an employee with 10 years of service retires at age 65, the annual benefit would be equal to 26.11 percent of final compensation. If final compensation was $30,000, the employee would receive an annual retirement benefit of $7,833. An employee with 10 years of service and $30,000 final compensation who retires at age 55, however, would receive an annual retirement benefit of $3,126. This benefit is 39.90 percent of the normal benefit and represents an average reduction of 6.01 percent for each of the 10 years before normal retirement age. An employee with the same service and compensation who retires at age 60 would receive a pension of $5,526 which is 70.55 percent of the normal benefit and represents a reduction of 5.89 percent per year.

Another reduction factor is one that differs for age brackets instead of changing each year. (See exhibit 2.) Among employees with early retirement provisions, 26 percent of private workers and 20 percent of public workers were subject to this provision.

In the example, normal retirement age is 65, but early retirement can begin at 55 if an employee has 10 years of service. The reduction factor is 3 percent a year between ages 60-64 and 5 percent a year between ages 55-59. An employee retiring at age 61 would receive 88 percent of the normal benefit [100 - (4 years x 3 percent)], while an employee retiring at age 56 would receive 65 percent of the normal benefit [100 - (5 years x 3 percent + 4 years x 5 percent)].

Reduction varies by service. In some plans, an employee's years of service is a factor in the early retirement reduction. In one form, the reduction *period* varies by years of service. For example, a plan may require a minimum of age 55 and 10 years of service for early retirement. If an employee has less than 30 years of service, his pension is reduced 5 percent for each year before age 65. If an employee has 30 years of service or more, the reduction period is only until age 62. This means that Employee A who retires at age 60 with 10 years of service would face a pension reduction of 25 percent (65-60 = 5; 5 years x 5 percent = 25 percent). Employee B who also retires at age 60, but with 30 years of service, would face a reduction of 10 percent (62-60 = 2; 2 years x 5 percent = 10 percent). Assuming a normal monthly benefit of $500 for all employees, Employee A would receive a pension of $375 per month, while Employee B would receive a pension of $450 per month.

In another form the reduction rate varies by years of service. For example, a plan might allow employees with 25 or more years of service early retirement at age 50. An employee whose length of service is less than 30 years is subject to a reduction factor of 6 percent for each year before age 55; for an employee with 30 years' service or more, the factor is 3 percent. Employee A, who retires at age 52 with 27 years of service, would face a pension reduction of 18 percent (55-52 = 3; 3 years x 6 percent = 18 percent). Employee B, who also retires at age 52, but with 30 years of service, faces a 9 percent reduction (55-52 = 3; 3 years x 3 percent = 9 percent). Assuming a normal benefit of $500 for all employees, Employee A's reduced monthly benefit would be $410, while Employee B's benefit would be $455.

Early retirement supplements

The age at which a defined benefit plan participant can take early retirement is often earlier than that for collecting Social Security retirement benefits. A few plans provide monthly early retirement supplements that generally last until age 62, the earliest age at which Social Security retirement benefits are payable. Some employers use these supplements to induce older workers to retire, while other employers use them to reward workers for longevity. To receive these benefits, workers must often meet age or service requirements more stringent than those for early retirement. Ten percent of private sector workers participated in defined benefit plans with this feature; less than 0.5 percent of public employees had this option.[10]

Conclusions

Data from the 1993-94 Employee Benefits Survey show that most workers participating in defined benefit pension plans had provisions for early retirement. The greatest proportion of workers covered by such provisions were in plans with variable early retirement reduction factors.

Defined benefit plan incentives have been considered a factor influencing the early retirement trend. The decline in the proportion of workers covered under these plans, however, could slow down or reduce the number of early retirees.[11]

The availability of retiree health coverage could also influence the early retirement trend. Existing research indicates that employer-provided retiree health coverage increases the probability of retirement for workers under age 65.[12] Without employer-provided retiree health coverage, workers retiring before age 65 face higher outlays, other factors being equal, than retirees over 65, many of whose health care expenses are reimbursed by Medicare. It should be noted that the proportion of employees with medical care coverage who also have employer-provided retiree coverage has not changed much in recent years.[13] The decline in the proportion of employees with medical care coverage, however, has reduced the number of employees in plans with retiree coverage[14] and could slow or reduce the number of workers retiring early.

The 1983 Social Security amendments, which made significant changes in benefit eligibility, could further reduce the number of early retirees. Beginning in the year 2000, the normal retirement age for Social Security eligibility will be gradually increased until it reaches 67 in 2022. The early retirement benefit amount, payable at age 62, will be reduced over this period. This is because the maximum early retirement reduction will increase from its present 20 percent to 30 percent for those who reach age 62 in the year 2022 or later.[15] Since it is likely that many workers reaching age 62 in the year 2000 or later will lack the financial resources to make up this difference,[16] they will probably have to continue working in order increase the adequacy of their retirement resources.

Defined benefit pension plan: A retirement plan that uses a predetermined formula to calculate a participant's benefits.

Benefits are generally based on a participant's salary and years of service with the employer sponsoring the plan.

Early retirement: The point at which defined benefit pension plan participants can retire and receive all accrued benefits less a reduction for the years prior to their normal retirement age.

Normal retirement: The point at which defined benefit pension plan participants can retire and receive all accrued benefits.

[1] Information from "Trends in Labor Force Participation of Major Population Groups, 1965-1992," Bureau of Labor Statistics, Division of Labor Force Statistics, July 1993(unpublished) and *Employment and Earnings*, January 1996, p. 160.

[2] For more information see *Employee Benefits in Medium and Large Private Establishments, 1993*, Bulletin 2456, Bureau of Labor Statistics, 1994, and *Employee Benefits in State and Local Governments, 1994*, Bulletin 2477, Bureau of Labor Statistics, 1996.

The Employee Benefits Survey also includes small private establishments (those with fewer than 100 workers). Because of low coverage rates (only 15 percent of full-time workers participated in a defined benefit pension plan) and high nonresponse rates in the 1994 survey, detailed provisions of defined benefit pension plans were not reported. For more information see *Employee Benefits in Small Private Establishments, 1994*, Bulletin 2475, Bureau of Labor Statistics, 1996.

[3] Early retirement trends have been examined in previous research using Employee Benefits Survey data. For more information see Olivia S. Mitchell, "Trends in Pension Benefit Formulas and Retirement Provisions," in John A. Turner and Daniel J. Beller, eds., *Trends in Pensions 1992*, U.S. Department of Labor, Pension and Welfare Benefits Administration, 1992, pp. 177-216.

[4] While 65 is the normal retirement age for current Social Security retirement recipients, 52 percent of defined benefit pension plan participants in medium and large private establishments could retire before age 65 and still receive normal (unreduced) benefits; among comparable State and local government employees, the proportion was 92 percent. When plans permit normal retirement before age 65, they usually impose a minimum service requirement, for example, 10 years of service at age 62.

[5] For more information about the Employee Retirement Income Security Act of 1974 see *What You Should Know About Your Pension Rights*, U.S. Department of Labor, Pension and Welfare Benefits Administration, 1995.

[6] For more information see Kristen Phillips, "State and Local Government Pension Benefits," in Turner and Beller, eds., pp.341-392.

[7] Participants in plans with a sum of age plus service or with a service requirement only could be eligible to retire at or before age 55 if they joined the plan at a relatively young age. If these participants are included, 89 percent of private employees and 97 percent of public employees could potentially retire at or before age 55.

[8] The worker's benefit will probably be less than 80 percent of what he would have received at age 65. This is because the benefit computation made at age 65 would most likely be based on a higher salary and more years of service than at age 61.

[9] Olivia Mitchell's examination of earlier EBS data uncovered the same pattern. She found that in 1989 two thirds of all workers in medium and large private establishments covered by a uniform early retirement reduction factor faced benefit reductions less than 6 percent. See Turner and Beller.

[10] Data from the 1988 Employee Benefits Survey were used to examine supplemental retirement payment provisions in defined benefit pension plans. For more information see William J. Wiatrowski, "Supplementing Retirement Until Social Security Begins," *Monthly Labor Review*, February 1990, pp. 25-29.

[11] In 1993, 56 percent of full-time employees in medium and large private establishments participated in a defined benefit pension plan, down from 63 percent in 1989. The proportion of State and local government employees participating in defined benefit pension plans was similar in 1990 and 1994, 90 percent and 91 percent, respectively.

[12] See Alvin E. Headen, Jr., Robert L. Clark, and Linda Shumaker Ghent, "Retiree Health Insurance and the Retirement Timing of Older Workers," (Unpublished) August 1995, and Lynn A. Karoly and Jeannette A. Rogowski, "The Effect of Access to Post-retirement Health Insurance on the Decision to Retire Early," *Industrial Relations Review*, Vol.48, No. 1 (October 1994), pp. 103-123.

[13] In 1993, 40 percent of employees in medium and large private establishments who had health insurance were in plans that had retiree coverage, either fully or partly financed by their employer, slightly lower than the 42 percent in 1989. In 1994, 60 percent of public employees with health care coverage had (fully or partly) employer-financed retiree coverage compared to 58 percent in 1990.

[14] The proportion of employees in medium and large private establishments with medical care coverage was 82 percent in 1993, down from 92 percent in 1989. The proportion of public employees with medical care coverage was 87 percent in 1994, down from 93 percent in 1990. It is difficult, however, to determine the impact of these declines on eventual retiree coverage because it is possible that some of these workers may have declined coverage because they were covered under another family member's plan.

[15] For more information on Social Security see *Fundamentals of Employee Benefit Programs*, 4th ed, Washington DC, Employee Benefit Research Institute, 1990, pp. 13-23.

[16] For more information see Paul Yakoboski and Celia Silverman, "Baby Boomers in Retirement: What are Their Prospects?" in Dallas L. Salsbury and Nora Super Jones, eds., *Retirement in the 21st Century... Ready or Not.*. Washington, DC, Employee Benefit Research Institute, 1994, pp. 1-62.