# Retirement Planning Recent Developments in Puerto Rico

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# Agenda

Local Economic Environment
Trends in Qualified Labor
Current Retirement Issues Affecting Puerto Rico
Retirement Options
Summary & Recommendations
Latest Developments
Q&A

# Speakers

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# A Welcome Actuarial Loss

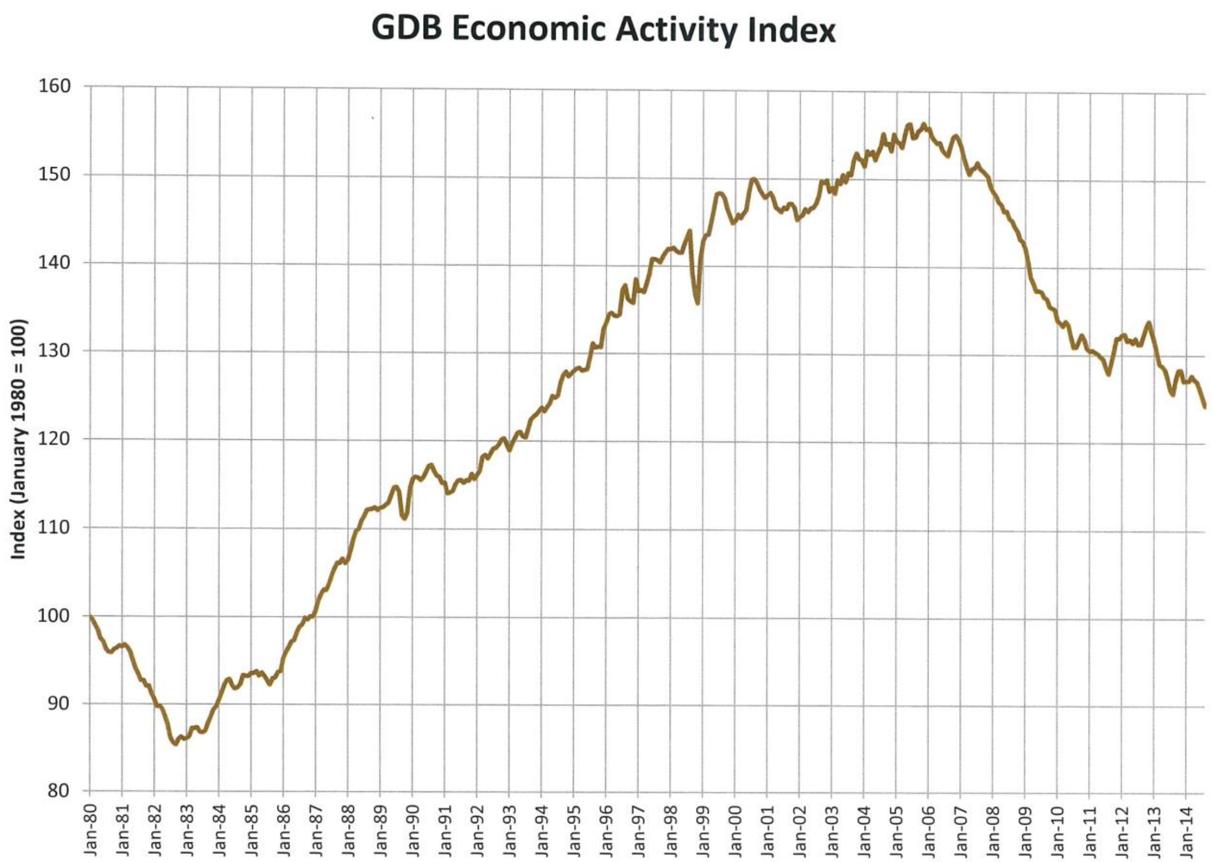

"He's 104. He always comes back on his birthday - I worked out he'd be gone at 69."

# Local Economic Environment

- For many years, the role of savings in economic growth has attracted a lot of attention.
- Economists generally agree that there is a direct correlation between a countries' pension assets and economic growth.
- Pension assets can be thought of as part of the total savings of a country.
- Must remember that (over the long haul) retirement readiness lifts economic output.
- Puerto Rico should be no exception.

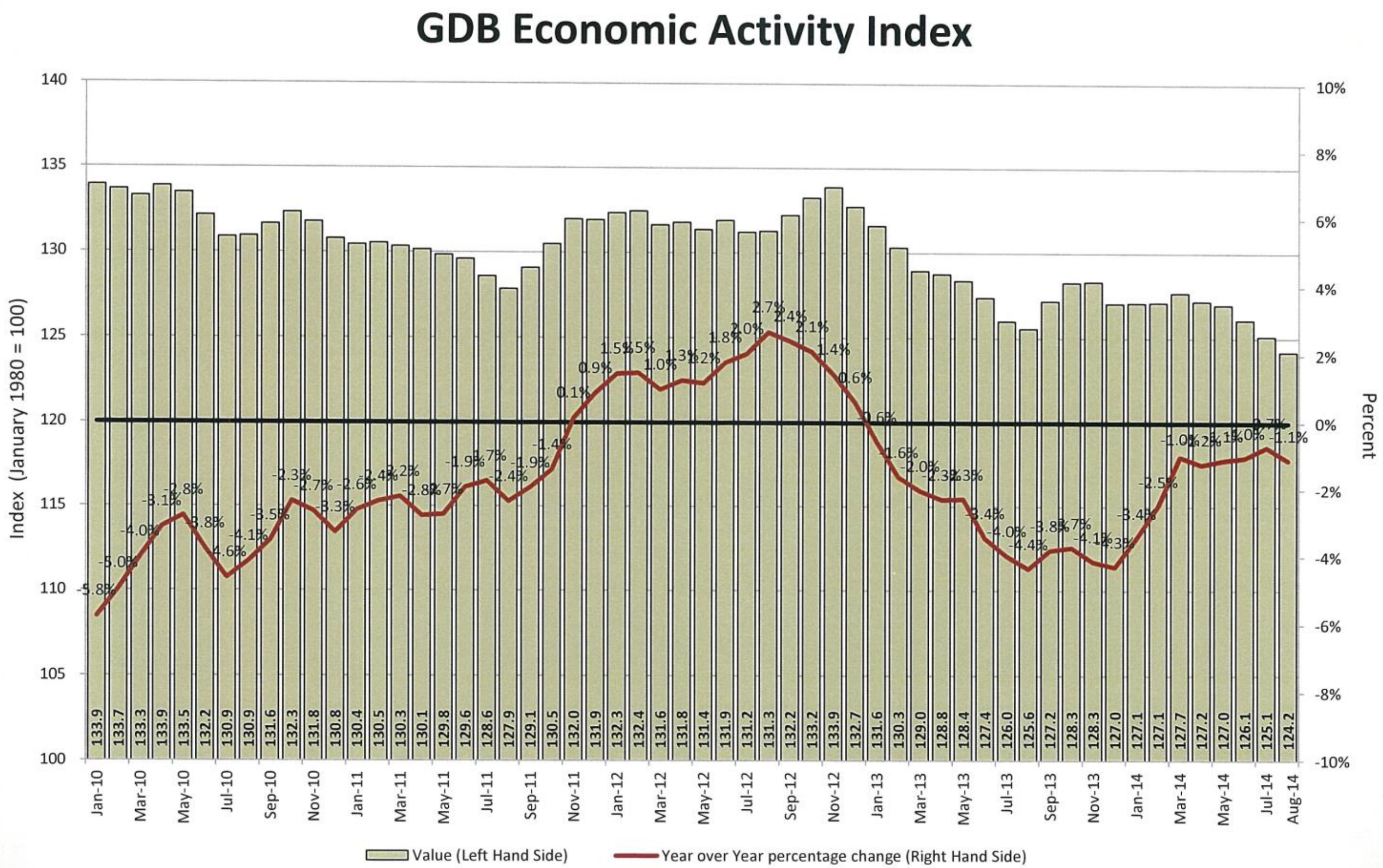
# Local Economic Environment

- The complete series of the new EAI, which starts in January 1980, shows the recessions of FY1982 and FY1983, and the mild recession of FY1991, the recession of 2001. It also shows the path of the Index since the beginning of the current recession.



# Local Economic Environment

- The GDB-EAI registered a 1.1% year-over-year reduction in August, after showing a 0.7% y-o-y decrease in July 2014.



# Local Economic Environment

Average Real GNP Growth Rate (2000 – 2013): **(0.07%)**

## Clarification about the interpretation of the GDB-EAI figures (2)

Here is a comparison of the annual growth rates of the GDB-EAI with the actual real GNP figures. There are also estimates of the annual growth of the real GNP using the figures coming from the GDB-EAI.

| Fiscal Year | EAI Annual growth | Real GNP annual growth estimated using the EAI | Actual Real GNP annual Growth |
|---|---|---|---|
| 2000 | 2.9% | 2.8% | 3.0% |
| 2001 | 1.1% | 1.4% | 1.5% |
| 2002 | -1.2% | -0.2% | -0.3% |
| 2003 | 1.8% | 2.0% | 2.1% |
| 2004 | 2.0% | 2.2% | 2.7% |
| 2005 | 1.6% | 1.8% | 1.9% |
| 2006 | 0.3% | 0.8% | 0.5% |
| 2007 | -1.3% | -0.4% | -1.2% |
| 2008 | -2.5% | -1.2% | -2.9% |
| 2009 | -4.9% | -3.0% | -3.8% |
| 2010 | -4.9% | -3.0% | -3.6% |
| 2011 | -2.9% | -1.5% | -1.7% |
| 2012 | 0.1% | 0.7% | 0.9% |
| 2013 | -0.1% | 0.6% | 0.3% |

- Notice that the real GNP growth estimates coming from the EAI are relatively close to the actual real GNP growth figures.

# Local Economic Environment

## Summary

- Economy's downward trend is expected to continue for several years.
- Future may not be so bright if we do not encourage more savings, particularly for "golden years."
- Deadly combination of a declining economy, an aging population, and an exodus of qualified labor will represent a formidable challenge for companies that want to survive and succeed.

# Trends in Qualified Labor

elnuevodia.com

29 de septiembre de 2013
Puerto Rico Hoy

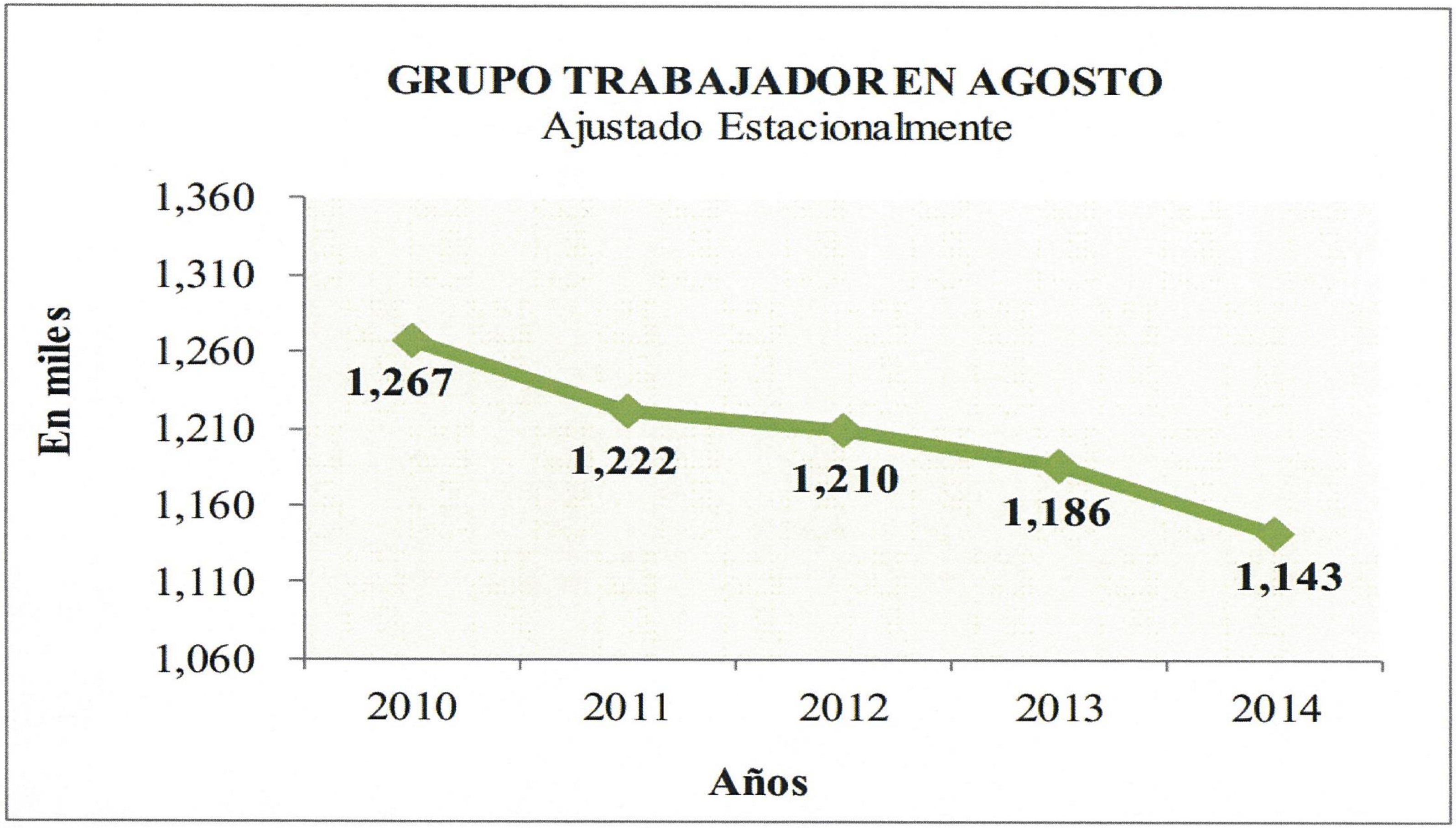
## Un pueblo desangrado por la emigración

*Al ritmo actual, Puerto Rico tendrá en el 2050 la misma cantidad de habitantes que tenía en el 1950*

Por José A. Delgado / jdelgado@elnuevodia.com

WASHINGTON – Las proyecciones son tan indisputables como alarmantes: el alto éxodo de puertorriqueños hacia Estados Unidos, solo comparable con la gran emigración de mediados del pasado siglo, es la nueva norma.

# Trends in Qualified Labor




Source: PR Department of Labor and Human Resources

# Trends in Qualified Labor

- Economy will trigger use of “escape valve” by qualified professionals.
- you have probably experienced or heard of a doctor, dentist, accountant, mechanic, teacher, or friend with a college degree who has left the Island looking for a better horizon.
- The impact on hiring and retention of qualified professionals will be brutal in years to come…you may already be experiencing!

# Current Retirement Issues Affecting Puerto Rico

- Lack of retirement savings is forcing older employees to stay working, thereby significantly increasing costs for employers (most of which are real, but difficult to quantify):
  - higher salaries
  - more vacation
  - more sick time
  - higher benefits costs for entire workforce (medical, life insurance, dental, disability insurance, etc.)
  - rise in ADEA lawsuits and litigation
  - decrease in productivity
  - increase in “special” severance packages

# Current Retirement Issues Affecting Puerto Rico

- Lack of a "savings" culture. Mentality of "la última la paga el diablo."
- Gradual dismantling of government pensions that guarantee an annuity for life.
- Slow disappearance of defined benefit pensions in the private sector.
- Inability for meaningful savings given high taxes and high cost of living, particularly at lower salary levels.
- Ability to withdraw retirement savings for multiple reasons prior to retirement is too easy.
- There is not much understanding of what it takes to survive 20-40 years with savings accumulated.
- Many hope government will come in to help.

# Retirement Options

Will it come down to this?


"It's the new man - he wants to know what the company retirement plan is."

# Retirement Options

The Economist

**Buttonwood**

## Work until you drop

### Ageing societies create many employment challenges

Oct 11th 2014 | From the print edition


THE developed world is heading into what Shakespeare described as "second childishness and mere oblivion, sans eyes, sans teeth, sans taste, sans everything". The share of the population aged over 65 in rich countries will rise from 15% in 2010 to 27% by 2050, while those aged over 80 will increase from 4% to 9%. While this trend is well known, countries are only just starting to grapple with the implications. The issue was the subject of a conference held at the London School of Economics last month.

Source: The Economist Magazine

# Retirement Options

## The Power of Compound Interest

Let us assume Juan Naranjito (age 22) starts saving for retirement with a monthly IRA deposit of **$100** and a return of 6.00% per annum in his investment. Let us also assume we know that Juan plans to retire at age 62 and, unfortunately, die at age 82, using up his entire savings.

At age 62 his savings plus interest will accumulate to approximately **$191,000**. Juan can withdraw annually about **$15,700** (about $1,300 a month until death) to drain his entire savings when he dies at age 82.

If Juan had waited and started at age 30 we would have had to save **$170** a month to receive the same amount at age 62. At age 40 about **$360** a month would be required and at age 50 approximately **$975** a month are necessary for the same level of retirement income.

**Thinking that retirement is just too far into the future is a major mistake**!

# Retirement Options

## Types of Retirement Plans Available

- **Defined Benefit**: retirement benefit payable for life based on a formula specified in a plan document. Risk is entirely the plan sponsor's.
- **Defined Contribution**: employer contribution is generally a fixed amount defined in a plan document. Risk is entirely the participant's.
- **Hybrid**: combination of "defined benefit" and "defined contribution." Risk is shared between plan sponsor and participant. Approach best suited for Puerto Rico's retirement idiosyncrasies.

# Retirement Options

## Defined Benefit Plan

Example

Benefit formula is 2% of the final average earnings (5-yr average) multiplied by years of service with employer (maximum 30 years) which is payable as a life annuity:

Final 5-yr average salary at age 65: $30,000

Years of service with employer: 40

Benefit payable as a life annuity is

2% x $30,000 x 30 = $18,000.

Retiring employee will receive a life annuity of $1,500 monthly.

**Employer must make whatever contributions are necessary (usually computed by an actuary) to make sure promised benefits are paid to all plan participants.**

# Retirement Options

## Defined Contribution Plan
Example

Each participant has an individual account (like a savings account).

Individual account grows with employer and employee contributions and increases/decreases with earnings/losses in investments. Most common:

- **Money Purchase Plan**: employer contribution to individual account is 5% of the employee's basic salary.
- **Profit Sharing Plan**: employer contribution to individual account is based on a percentage of the employer's profits (usually prorated based on salary).
- **Plan 401(k) / 1165(e) / 1081(d)**: plan sponsor matches $0.50 for every dollar saved by the employee to a maximum of 6% of the employee's salary.

**Plan sponsor's responsibility is to make the specified contribution. Retirement benefit will be variable depending on amount accumulated in individual account. Retirement risk is borne by the participant.**

# Retirement Options

## Hybrid - Target Benefit Plans

Example

- Defined benefit (DB) retirement plans have been maligned because of their complexity, costs, administration, compliance, reporting, disclosure, etc.

- Investment risk on DB plan is borne by plan sponsor (i.e., market losses are made up by increasing employer contributions).

- Defined contribution (DC) retirement / savings plans (such as profit sharing, 401(k) / 1165(e) / 1081(d), etc.) are thought as simple and less costly plans but do not provide enough retirement income, particularly for upper management/professional echelon. Maximum account annual addition limited to $52,000 in 2014.

- Allocation of profits is generally based pro-rata on earnings or a combination of earnings and service. 401(k) / 1165(e) / 1081(d) plan has a $15,000 dollar maximum employee elective deferral ($16,500 with the catch up).

**Investment risk on DC plans borne entirely by plan participants (i.e., market losses reflected in lower employee account balances).**

# Retirement Options

## Hybrid - Target Benefit Plans
Example

- Target benefit plans offer a compromise that involves the best features of both defined benefit (DB) and defined contribution (DC) plans.
- Considered by the IRS and Hacienda as a DC Plan, a target benefit plan is a hybrid of a "money purchase plan" and a "defined benefit plan."
- Like a money purchase pension plan because employer contributions are required each year to a participant's "individual account."
- Like a defined benefit plan because an annual contribution is actuarially determined at the outset to accumulate to a "target benefit" at the participants normal retirement date.
- Once the "target benefit" is set, the actuarially determined employer contributions are deposited annually into the participant's individual account, which then bears the investment risks.  Therefore, the "target benefit" is not guaranteed.

# Retirement Options

## Hybrid - Target Benefit Plans

Example

- Benefits are only a “target” which may or may not be achieved depending upon the individual account earnings.
- Even if the “target benefit” is achieved, there is no guaranteed lifetime benefit unless the funds are transferred into an annuity contract.
- Annuity contract benefit may differ from actual target benefit depending on annuity pricings at the time of purchase.
- Employer may manage the investments or, like in 401(k) plans, employees may direct investment of their target benefit accounts, thereby reducing the fiduciary liability.
- Forfeitures (of non-vested terminated participants) are used to reduce required employer contributions.

# Retirement Options

## Hybrid - Target Benefit Plans

Example

Target is 50% of a participant's final average earnings, starting at age 65. Participant is currently age 45 and earns $60,000 a year. Assuming a 4% salary increase, the final average earnings at age 65 is expected at $117,054.

Target benefit here is 50% of $117,054, or **$58,527** a year, for life.

Using the GAM 94 mortality table (50/50, projected to 2002) and 6% interest the present value of this amount at age 65 is **$633,496** and the amount that must be added **annually** to this participant's account to accumulate to that amount (again, assuming 6% interest earnings) is **$16,247**.

**The $16,427 goes into the participant's individual account, which increases or decreases with gains and losses up to the retirement age, earlier termination of employment, death or disability. A valuation must be performed every year to determine/rebalance this annual contribution to the individual account.**

At retirement, the participant can take a lump sum (with spousal consent) or buy an annuity with whatever amount is in his/her account. Annuity amount may differ from target, based on market conditions at the time of retirement.

# Retirement Options

## Alternative for Small Employers – Recent Trends

- Small employers (generally *doctors,* lawyers, accountants, self employed, etc.) that used defined contribution Keoghs in the past to fund their retirement benefits are now affected by $52,000 annual addition dollar limitation.

- Defined benefit plans, where the annual required contribution is determined by an actuary, is a pretty good alternative, particularly for those close to age 65 with little money saved for retirement.

- Defined benefit plan is NOT subject to many of the complexities and administrative costs of regular defined benefit plans.

- Plan sponsor pays no PBGC premiums.

- Allows accumulation of significant retirement funds in a tax effective fashion over a relatively low period of time.

# Summary & Recommendations

- Local economy and recruiting of qualified labor will represent formidable challenges to local employers for many years into the future.
- Ability to withdraw retirement savings prior to retirement age must be reevaluated, given lack of enforcement and tendency to take money out for non-retirement reasons.
- Lack of retirement savings will have a significant effect on other employee benefit costs as well as on payroll, severance packages, and employer legal costs.
- Plan sponsors must invest in retirement counseling and education to increase awareness of the financial impact of 20-40 years of retirement.
- In Puerto Rico, hybrid plans represent best compromise for decent retirement and will translate into significant savings in the future.
- Smaller employers that need to accumulate significant savings for retirement may want to consider a defined benefit plan for its workforce.
- At the individual level, IRAs can help cushion unexpected retirement expenses.

# Latest Developments

- Plan Filings with Hacienda  under Puerto Rico internal Revenue Code of 2011.
- Law 77-2014 providing for tax prepayment of plan benefits.
  - Administrative Determination 14-16
  - Circular Letter 14-02
- Senate Bill 1189, extending deadline for prepayment.

# Q&A