



Defined Benefit Plans

What is a Defined Benefit Plan?

A defined benefit plan promises a specified monthly benefit to participants at retirement. The benefit payable to an employee is based on a formula set forth in the plan that often takes into consideration service and compensation. The commitment of the employer is to satisfy funding requirements to provide retirement benefits. An actuary who performs services for the plan will calculate annually how much the plan sponsor must contribute. If the plan is “fully funded”, meaning that the current asset amount, assuming a given rate of return and a particular group of employees, will meet the obligations of distributions at date of retirement, no contributions may be required.

Why would an employer choose a defined benefit plan over another type of qualified plan?

Smaller companies adopt defined benefit plans to allow significant funding opportunities and retirement savings for owners and key employees who may be older with many years of service. Defined benefit plans can offer the largest qualified plan contributions, often far exceeding defined contribution plan maximums. Many larger companies sponsor defined benefit pension plans to attract and retain employees or provide long-term benefits to career employees.

What should be considered when establishing and maintaining a defined benefit pension plan?

- Companies who sponsor defined benefit plans should have sufficient ongoing cash flow to fund a required annual contribution amount
- In addition to funding costs, employers will incur some costs for services to the plan, including actuarial and administrative fees

Features	Defined Benefit (DB)	Defined Contribution (DC)
Annual funding flexibility	Requires contributions to be made on an annual basis.	May be designed to have discretionary contributions.
Investment risk	Employer assumes investment and possibly inflation risk.	Employee assumes the investment risk.
Access to funds	No pre-retirement access to accounts is normally provided.	Pre-retirement access to accounts is often provided, in the form of loans or hardship withdrawals.
Integration with Social Security Benefits	Plan fulfills a specific retirement income objective (e.g., replacing 60% of pre-retirement income with Social Security and pension benefits). Therefore, Social Security integration is accomplished more efficiently under defined benefit plans.	Integration can be accomplished, but the process focuses on disparity in contributions and does not attempt to target a specific replacement ratio.
Benefits Accumulation	Accumulation of a significant benefit takes time as years of service are considered in the benefit formula.	Shorter tenure employees may accumulate more substantial benefits under a DC plan.
Forms of benefits provided at retirement	Benefits are <i>usually</i> paid in the form of life annuities.	Benefits are usually paid in the form of lump-sum distributions.
Approach to Investing	Investment allocations in DB plans are modeled to accomplish the actuarial assumptions of the plan.	DC plans usually give investment direction to employees to invest for their retirement on an individual basis.