Defined Benefit Plans (DB) vs. Defined Contribution Plans (DC)

Defined Benefit Plan (traditional pension or fixed pension) – A pension plan under which an employee receives a set monthly amount upon retirement, guaranteed for their life or the joint lives of the member and their spouse. This benefit may also include a cost-of-living increase each year during retirement. The monthly benefit amount is based upon the participant's wages and length of service.

Defined Contribution Plan – A retirement savings program under which an employer promises certain contributions to a participant's account during employment, but with no guaranteed retirement benefit. The ultimate benefit is based exclusively upon the contributions to, and investment earnings of the plan. The benefit ceases when the account balance is depleted, regardless of the retiree's age or circumstances. Examples of such plans are 457, 401(k), and 403(b) plans.

1. Historically, wages for government and education employees have been lower than for the private industry. In return, retirement benefits have usually been higher. Switching to a DC plan and phasing out DB retirement benefits will require that wages increase in order to become more competitive, offsetting any potential savings the employer may have realized from shifting to a DC plan.

2. By only providing a retirement benefit which is totally portable (such as a 401(k) or 457 plan) government and education run the risk that highly-trained employees who had an incentive to remain in their careers due to a desire to earn a 30 year retirement benefit, will be willing to leave their positions for opportunities in the private sector. The result will be much higher turnover in positions and less loyalty from senior employees, fewer experienced employees and educators, and a more transitory workforce. Also, there will be little "institutional memory".

3. Introducing a DC only benefit will not eliminate the necessity of continued maintenance of the DB plan. The DB plan will need to be administered for those current retirees and also for all of those members who have vested service. (The DB plan will require administration for the next 75+ years!) In addition, there would be added administrative costs for running two plans. Recent discussions in California have focused on eliminating all public DB plans and replacing them with DC plans. The consulting actuary for the California State Teachers Retirement System (CalSTRS) has projected that adopting a mandatory DC plan would increase required contributions by $900 million between years 2006 and 2017. Not until the year 2028 will there be sufficient savings realized to cover this increased contribution. This cost is for only one of the many retirement systems in California.

4. The cost for the DB plan would climb if the plan is closed. This would be caused because there would be no new members entering the plan who may terminate prior to vesting, thus forfeiting their contributions and helping to fund those employees who remain in the plan. Actuarially, a closed plan is more costly

because there is a smaller population to spread the costs over. Also, the time horizon over which costs can be spread is much shorter, meaning that cost increases must be funded over a shorter period resulting in much larger increases. Governmental Accounting Standards Board Statement No. 25 also requires a shorter period for amortizing costs and unfunded liabilities, making DB plans which are closed much more expensive to administer.

5. There is a social cost for eliminating the DB plan. If public employees do not have enough income at retirement to support themselves, the welfare system of the state could be called upon to provide support.

6. Experience (Nebraska - see attached) has shown that DC only plans produce a smaller benefit at retirement than a DB plan, even when the same dollars are invested. Nebraska's experience found that money which is managed and invested by a professional staff into a DB plan earns higher returns, on average, than money invested by individual members into a DC plan. Even with 30 years of experience and training, DC participants do not invest as well, nor realize returns as high as a professionally managed DB plan.

7. If the DB plan is closed to new hires, the assumption then becomes that the DB plan is not set up in perpetuity and thus the time horizon of the investments will require a change to more liquid investments. The allocation of investment dollars to the top performing investment classes such as real estate and private equity would need to be reduced or even eliminated, resulting in a decrease in the potential return on investments, causing even more costs to fund the DB plan.

8. The current retirement plan for public employees in Utah has both a DB and a DC component. This balanced approach provides for a more secure retirement benefit for participants than one which relies on a single option. The current DC plan allows members to select among various options for investing while still being able to rely on stable retirement income from their DB plan. Eliminating the DB benefit will place the member's entire retirement benefit at the mercy of market performance.

9. Leakage is a key reason DC plans are unreliable vehicles for ensuring retirement income security. Leakage refers to the loss of assets before retirement to such factors as loans (especially those that are not repaid by the participants) and by cashing out retirement savings when they change jobs (rather than leaving them in the existing plan - or by rolling them to an Individual Retirement Account or to a future employer's retirement plan). Studies consistently indicate that half or more of terminating participants fail to retain their retirement assets in a retirement savings account.

10. As a group, employees are generally poor investors, engaging in such practices as market timing, taking too much or too little risk, neglecting or over-managing their account, or not allocating their assets among different asset classes. The frequent result of these factors is insufficient retirement savings. Efforts to

educate workers regarding making better investment decisions often produced limited success because of their unwillingness to take the necessary time or effort.

11. About one-fourth of all public employees do not participate in Social Security, making their employer pension their primary source of financial security. Switching their DB pension to a DC only plan will expose many of these workers to the dangers of insufficient retirement savings.

12. A DB plan assists employers by promoting orderly turnover. DB plans also enable participants to qualify for a benefit on the basis of their age and service. In contrast, by determining retirement eligibility by the adequacy of savings, DC plans provide neither employers nor employees assurance of retirement eligibility when employees would normally retire. This can result in employees remaining on the job long after their productivity has declined.

13. The administrative cost of a DB plan is substantially lower than for a typical DC plan. The median cost of a DC plan is approximately 1.40% (industry wide); the median cost of a statewide DB plan is approximately 0.30%. The higher DC plan expenses reduces the assets available for benefits. (Based upon information published by the National Association of State Retirement Administrators.)

14. Most employees prefer a DB plan. In recent cases in two large states – Ohio and Florida – where large numbers of employees were given a choice between a DC plan and a DB plan, overwhelming percentages of workers chose to participate in the DB plan.

15. A DB plan is a life-time annuity which the member cannot out live. If the member chooses, a reduced benefit may be selected, which provides a continuing benefit to the spouse should the member predecease their spouse.

16. Timing is critical to the success of a DC plan. If a member retires in a down market, the funds withdrawn will reduce the principal upon which the member was relying to produce future investment earnings, resulting in either lower monthly income or a shorter period of retirement income. Also, at the bottom of a market cycle employees may not be able to afford retirement, regardless of their age or health.

17. DB plans offer both disability as well as line-of-duty death benefits. They may also offer a reduced lifetime benefit for a surviving spouse if the member was employed for a minimum number of years, e.g. 15 years. DC plan benefits are based only on the amount which has been deposited to and earned in the account. Members who are disabled or lose their life in a line-of-duty death early in their career will not have accumulated sufficient assets to support their spouse and family.

Nebraska's Experience with Defined Benefit and Defined Contribution Plans[1]

Nebraska presents an interesting case study in the DB/DC debate. While other states have recently adopted DC plans, Nebraska adopted one over thirty years ago. In the mid-sixties, the Nebraska Legislature authorized two statewide defined contribution plans: one for state government employees and another for country government employees. Prior to the creation of these plans, there was no employer-sponsored retirement plan for those employees. In previous decades, Nebraska had created DB plans for school employees, state judges and state patrol employees. In choosing a DC plan over a DB plan, the historical record reflects that the Legislature was concerned about unfunded liabilities in the existing DB plans.

Sullivan (Anna Sullivan, Director of the Nebraska Public Employees Retirement System) sums up Nebraska's experience by stating, "Our experience with the defined contribution plans has been mixed. We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."

She notes that the administrative costs of a DC plan are high. In Nebraska, they spend more in investment management fees, record-keeping fees, educational programs and material with the defined contribution plans than with the defined benefit plans. In 1999 Nebraska's plan expenses for their defined contribution plans were approximately 30 basis points (BP) versus 15 BP for their defined benefit plan.

Nebraska commissioned a study to review the benefit adequacy of the Nebraska Retirement System. In 1994, Buck Consultants completed a study which measured the purchasing power of estimated lifetime income as a percentage of final salary. They looked exclusively at employees who worked a thirty year career with the state, and found that all of these employees would have a higher percentage of purchasing power based on their final salary under their DB plan.[2] In addition, a December 1998 study showed that pension plan participants fared better than their DC counterparts in Nebraska. The study found that ten years after retirement, a retiree with 30 years of service who had an average annual salary of $30,000 receives about $11,230 each year from a DC plan. A DB plan participant with similar pay and service credit receives $16,797 each year.[3]

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[1] House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 26.

[2] *Legislator's Guide to Nebraska Retirement Systems,* December 1998.

[3] Opdyke, Jeff, The Wall Street Journal, *"State Worker's Pension Plans Spark Debate,"* May 5, 2000.