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Understanding the Differences Between Defined Benefit Pension And Defined Contribution

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Fact Sheet
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Understanding the Differences Between Defined Benefit Pension Plans and Defined Contribution

In recent years, more and more employers are offering employees defined contribution plans instead of defined benefit plans. Although there has been a shift away from the defined benefit pension plan, it is important for employees to understand the difference and value of both pension plans.

Each type of pension plan has both advantages and disadvantages. What may appear as an advantage to one person might seem to be a disadvantage to another person. For example, a person who spends all or most of her career with a single employer will have very different concerns from someone who changes jobs many times over the course of her career. It is important to understand the factors highlighted below in light of your own particular work history.

Defined Benefit

- A **defined benefit** plan is a traditional pension plan, which pays a specific benefit, usually on a monthly basis, based on a formula that may include your age at the time of retirement, your rate of pay, and your length of service.
- Generally, all employees participate in these plans after meeting certain criteria pursuant to the employer's eligibility requirements; for example, participants must reach a certain age in order to participate; many companies require participants to be at least 21 years of age to enroll.
- The plan is funded by the employer or employers. The employer is responsible for keeping the fund sufficiently funded and for paying the monthly benefits promised by the plan. If the fund's investments do poorly, it is the plan sponsor's responsibility to invest more money to keep the fund properly funded. This is called the "investment risk"; in a defined benefit plan, the employer bears this risk.
- The plan sponsor must ensure the plan has enough money to pay the promised pensions for as long as the retirees live – whether they live to 66 or 106! This is

sometimes referred to as the “longevity risk”; in a defined benefit plan, the employer also bears this risk.

- As the above paragraphs indicate, in a defined benefit plan, both the investment risk and the longevity risk are the responsibility of the employer, not the employee.
- A defined benefit plan must always provide for survivor benefits for the spouses of retirees. The default form of benefit payment in a defined benefit plan is a 50% joint and survivor benefit. This means that, when the retiree dies, the retiree’s spouse receives 50% of the monthly benefit the retiree had been receiving for the rest of the widow or widower’s life. The spouse has the right to receive this benefit unless she or he has signed very specific paperwork giving up this right.
- Only the plan participant and surviving spouse can receive pension benefits after retirement; a defined benefit pension is generally not assignable to third parties.

Defined Contribution

- A **defined contribution** plan is one in which a defined amount is contributed into the plan by the employer, the employee, or both.
- Generally, employees may elect to participate in this retirement savings plan.
- The eventual payout depends on the amount contributed and the investment performance of the account.
- The money invested in the plan through employee and/or employer contributions may grow or may lose value, depending on how well the plan’s investments perform. The “investment risk” falls on the employee because, unlike defined benefit plans, there is no guarantee of any specified benefit amount at retirement.
- Some defined contribution plans provide employees with a heightened level of control over funds. Known as a self-directed retirement plan, employees have the power to choose how retirement assets are invested (i.e. stock market, bonds, mutual funds, etc.).
- There is also higher level of “portability” available with defined contribution plans. The employee may have the option to take a loan or hardship withdrawal while employed, and will be able to withdraw or roll over the account into some other plan or investment vehicle when he leaves employment with the plan sponsor.
- The “longevity risk” is completely on the employee. It is the employee’s responsibility to make the funds last as long as he or she needs them. If the investments do poorly, or he or she lives a long time after retiring, the employee may outlive the funds.
- An employee may elect any surviving beneficiary to receive the remaining value of the account upon his or her death.

DEFINED BENEFIT	vs.	DEFINED CONTRIBUTION
All employees	**Who participates?**	Employee usually elects
Yes	**Formula for benefits?**	No
Employer	**Who funds?**	Employee and/or employer
Yes	**Survivor's protection?**	Generally no
Possible	**Cost of Living Adjustment?**	No
Usually no	**Portability**	Yes
Employer	**Who Bears Risk?**	Employee

Do you have any questions about this fact sheet? Call the Pension Action Center at 888-425-6067 or visit us online at pension.umb.edu

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