

# Achieving Benefit and Cost Objectives

Choosing the  
Right Retirement  
Plan for Your  
Organization





## Understanding Key Retirement Plan Differences

There are basically two types of retirement plans; defined benefit plans, which provide a monthly pension benefit based on the plan's benefit formula, and defined contribution plans, which provide a retirement benefit based upon the individual employee's accumulated account balance.

### Defined Benefit Plans



Under a defined benefit plan, all assets set aside to fund benefits for plan participants are combined to provide benefits under the plan. The employer contributes to the plan's trust an amount which is estimated to be sufficient to provide the plan's benefits. These estimates are based on assumptions about future rates of interest, salary increases, mortality, turnover, and other factors. If the plan's experience differs from the estimates (for example, earning more or less investment return than expected, or there are greater or fewer terminations than expected), this will increase or decrease the amount of employer contributions needed in future years.

### Defined Contribution Plans



Under a defined contribution plan, each participant has an individual account which reflects his or her individual benefit. Employee, as well as employer matching contributions are added to this account, along with investment earnings, including any increases and decreases in market value of investments. The amount of the benefit at retirement will depend upon the size of yearly contributions, the number of years of participation, and the investment return earned.



**Favorable or unfavorable investment experience will impact the individual participant's benefit under a defined contribution plan, but will not affect the employer's costs. Under defined benefit programs, favorable or unfavorable investment experience, mortality and other factors will impact the employer's cost but will not affect the amount of benefits.**



## Which Type Of Plan Is Best?



Typically, employers feel that the primary objective of a retirement plan is to provide future retirement income to employees which, when combined with Social Security benefits and an employee's personal savings, will provide a sufficient level of income in retirement.



The employee's perception of the employer's goal and the method of meeting those goals has a definite impact on the success of a retirement program as it pertains to the employer's overall objectives. Defined benefit plans tend to be more difficult to understand. Promised benefits often seem remote and the current dollar value of the benefits is not apparent. However, as employees approach retirement, they come to understand and appreciate defined benefit plans.



Defined contribution plan participants have individual accounts, whose values are expressed in dollars and cents, rather than in benefit formulas. On an ongoing basis, employees can at any point in time definitively determine what their account value is. The complexity and uncertainty arises in determining the benefit that the individual's account will provide at retirement. The amount of annual contributions and investment returns have a great deal to do with the ultimate benefits provided by defined contributions plans.



In addition to providing a monthly retirement income for employees, employers may have other goals to accomplish through their retirement program. One such goal may be the desire to reward career employees for long-term service. Defined contribution plans provide benefits based upon a career average salary and, therefore, are less favorable in terms of replacement ratios for long service employees than for short service employees. Though defined contribution plans are more easily understood and appreciated by younger employees, defined benefit plans favor career employees because they take an employee's final average salary and years of service into consideration. and at the same time provide more comprehensive benefit coverage. Defined benefit plans generally contain greater cost efficiencies as they provide higher benefits to retirees and less to terminated employees. In addition, while defined benefit plans may recognize past service, defined contribution plans cannot.



**The Ideal Combination of Plans Balances Benefit and Cost Objectives**



## Defined Benefit Plans

## Defined Contribution Plans

	Advantages	Disadvantages		Advantages	Disadvantages
<b>Employer</b>	<ul style="list-style-type: none"> <li>• Favors “career” oriented employees</li> <li>• More comprehensive benefit coverage</li> <li>• Integrates well with Social Security</li> <li>• Cost efficient; less to terminated employees, more to retirees</li> </ul>	<ul style="list-style-type: none"> <li>• Uncertain future costs</li> <li>• Requirements for audits and actuarial review</li> <li>• Investment risk with employer</li> <li>• PBGC premiums required</li> </ul>	<b>Employer</b>	<ul style="list-style-type: none"> <li>• Predictability of costs</li> <li>• No PBGC premiums</li> <li>• Less need for actuarial services</li> <li>• Investment risk with employee</li> </ul>	<ul style="list-style-type: none"> <li>• Difficult to integrate with Social Security</li> <li>• Predictability of benefits</li> <li>• More likely to provide lower benefits to career employees</li> </ul>
<b>Employee</b>	<ul style="list-style-type: none"> <li>• Provides past-service credit</li> <li>• Benefits typically based on final pay</li> <li>• Older, long-service employees receive larger portion of employer’s contribution</li> <li>• Favors “career” oriented employees</li> <li>• Provides known level of retirement income-increases employee security</li> <li>• PBGC insures plan benefits (up to certain limits)</li> <li>• Investment risk with employer</li> </ul>	<ul style="list-style-type: none"> <li>• Favors “career” oriented employees</li> <li>• Limited perceived value to young employees</li> </ul> 	<b>Employee</b>	<ul style="list-style-type: none"> <li>• Easily understood</li> <li>• Appreciated more by younger employees (withdrawal and loan provisions)</li> <li>• Increased flexibility</li> <li>• Favors “shorter” term employees</li> </ul>	<ul style="list-style-type: none"> <li>• No crediting of past service</li> <li>• Older employees may receive inadequate income</li> <li>• Due to compounding, greater weight is given to lower compensation received in early</li> </ul>



## The Combined Approach



Many employers believe the most efficient and effective retirement programs combine both types of plans, making use of the particular cost and benefit advantages of each. While a defined benefit plan is a sound and more secure basis for providing retirement benefits to career employees, younger employees may not appreciate the 100% employer paid benefit when retirement is years away. The addition of a defined contribution plan only increases an employees' responsibility for providing for their own retirement, but also increase employee enthusiasm and appreciation for the overall program. This is generally attributable to the increased control, flexibility and access to accumulated funds that a defined contribution plan provides. Thus, a combined program may not only better meet the employer's primary benefit goal of providing a lifetime monthly income in retirement, but also attract and retain employees more effectively in this increasingly mobile work force.



A combined retirement program has proven to be very attractive to employers who desire greater predictability of pension program costs than that available under a defined benefit plan alone, without sacrificing the capability of providing career employees with greater retirement security.



**A Combination of Plans is Ideal**



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