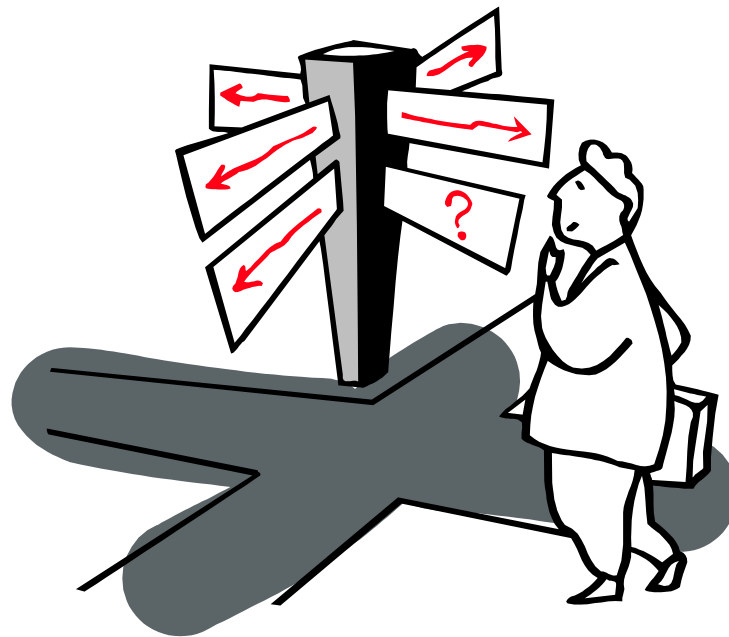


# Understanding Your Defined Benefit Pension Plan

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# What is a defined benefit pension plan?

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- A retirement benefit
- Sponsored by your employer
- Pays a defined amount upon retirement based on length of service and final average salary
- Defines retirement eligibility by the employee's age and years of service
- Retirement benefit is permanent and is guaranteed

# Other features of your defined benefit plan

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- Most defined benefit plans provide automatic or periodic cost-of-living increases to your retirement benefit to protect your benefit from inflation
- A survivor's benefit
- A disability benefit

# How is my DB retirement benefit calculated?

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- Your DB plan benefit is determined by a formula that multiplies your length of service, final average salary, and a retirement factor
- The annual benefit for an employee who retires with 20 years of service, a final average salary of \$50,000, in a plan with a retirement factor of 2.0%:

$$20 \times \$50,000 \times 2.0\% = \underline{\$20,000}$$

# How do I qualify for my DB pension benefit?

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## ➤ **Become vested**

- Vesting is the length of service needed to qualify for a retirement benefit
- Your vesting requirement is    years

# How do I qualify for my DB pension benefit?

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- **Attain eligibility for *normal* retirement**
  - You will qualify for a normal (unreduced) retirement benefit by reaching one of the following:
    - $x$  years of age
    - $x$  years of age with  $y$  years of service
    - $z$  years of age with  $aa$  years of service
    - Any combination of age and service that totals  $bb$  (known as the “Rule of  $bb$ ”)

# How do I qualify for my DB pension benefit?

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- **Attain eligibility for *early* retirement**
  - You will qualify for an early (reduced) retirement benefit by reaching  $x$  years of age with  $y$  years of service
  - Your early retirement benefit will be reduced from your normal benefit by  $x$  percent for each year (month) of service you have less than  $y$

# How do I qualify for my DB pension benefit?

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- **Apply for your retirement benefit**
  - Notify your retirement system 3 to 6 months before your scheduled retirement date of your intention to retire
- If you terminate employment prior to qualifying for retirement and are vested, **leave your contributions with your retirement system**

# What happens if I terminate employment and withdraw my contributions?

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- Typically, you will forfeit your retirement benefit
- You normally will receive your contributions plus accrued interest, less mandatory withholding of 20% for federal income taxes
- You may also be liable for withholding for state income taxes and a 10% federal penalty

# Your Retirement Benefit in Review

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- It is a *defined benefit*—based on your length of service, final average salary, and a retirement multiplier
- It is a lifetime benefit, guaranteed by your employer
- You qualify by vesting, attaining required levels of age and/or service, and leaving your contributions in the retirement plan

# DB Plans in the Public Sector

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- DB plans are the dominant retirement benefit among public employees
  - Approximately 90% of all public employees in the United States participate in a DB plan

# What other types of employer-sponsored pension plans are there?

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- Instead of a defined benefit plan, some employers offer a defined contribution plan (also known as a DC plan) as the employee's *primary* retirement benefit

# What is a defined contribution plan?

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- A retirement benefit
- Amount of the benefit is determined by contributions made by the employee and the employer plus the investment return on those contributions
- Contributions are held in individual accounts
- Individual participants are responsible for investing the assets in their DC account

# Examples of defined contribution plan types

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- The 401(k) is the most recognized type of DC plan
  - Used mostly by private and non-profit employers
- 403(b)'s and 457's are popular among public employers
  - Often used as supplemental defined contribution plans for public employees
- Individual Retirement Accounts (IRA's) also are a form of defined contribution plan, but are not employer-sponsored

# Differences between DB and DC plans

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- The amount of a DB plan retirement benefit is determined through a formula that includes the employee's length of service, final average salary, and a retirement multiplier
- The amount of a DC plan retirement benefit is uncertain
  - Investment returns are unknown
  - The participant's lifespan is unknown
  - The participant's rate of spending in retirement is unknown

# Differences between DB and DC plans

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- A DB retirement benefit is for life and is guaranteed by law in most states
- You can deplete your DC assets, which would end your DC benefit
- Your DC benefit is guaranteed only through the purchase of an annuity

# Differences between DB and DC plans

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- A DB retirement benefit provides a level of income consistent with the employee's salary and length of service
- A DC retirement benefit provides a level of income that may or may not be related to the employee's salary or length of service

# Differences between DB and DC plans

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- The employer is responsible for investing DB plan assets
- Employees are responsible for making investment choices for their DC plan assets

# Differences between DB and DC plans

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- In most cases, DB plan participants may not borrow from their account
- Many DC plans allow participants to borrow against their account

# Differences between DB and DC plans

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- DB plan assets are often not transferable to a future employer's retirement account
- Most DC plan assets are transferable to a future employer's DC retirement plan

# Differences between DB and DC plans

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- Under a DB plan, employees are able to retire when they reach a designated age, service level, or combination of age and service
- Under a DC plan, employees may be required to postpone retirement if they have not accumulated sufficient assets

# Differences between DB and DC plans

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- DB plans do not allow employees to manage their own assets
  - Employer assumes investment risk
- DC plans require employees to make decisions regarding the investment of their assets
  - Employee assumes investment risk

# Differences between DB and DC plans

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- Most DB plans offer retiring participants limited access to a lump sum payment
- DC plans generally allow retiring participants to take their entire account as a lump sum

# Differences between DB and DC plans

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- DB plans provide certainty and stability in retirement income
- DC plans provide little certainty regarding retirement income

# Differences between DB and DC plans

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- Annual contribution limits, established by the IRS, are much higher for DB plans than for DC plans
  - Lower DC plan limits reduce retirement savings

# Differences between DB and DC plans

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- For employers ...
- DB plans encourage orderly and regular turnover by establishing retirement eligibility on the basis of age and years of service
- Because DC plans provide no assured level of retirement income, a DC plan participant may need to continue working beyond normal retirement age due to insufficient savings

# Differences between DB and DC plans

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- For employers ...
- A DB retirement benefit encourages employee retention and longevity by basing the retirement benefit on length of service and final average salary
- A DC retirement benefit does little to encourage employee retention

# Differences between DB and DC plans

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- For employers ...
- The cost of a DB plan, paid as contributions, can change over time
- The cost of DC plan contributions can be fixed and certain

# Differences between DB and DC plans

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- For employers ...
- A DB plan allows employers to meet targeted retirement income levels
- DC plans can not assure the retirement income needs of employees

# Differences between DB and DC plans

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- For employers ...
- A DB plan can accumulate an unfunded liability, which requires additional contributions from employers, employees, or both
- DC plans do not accumulate an unfunded liability; employers may retain a steady contribution rate

# Differences between DB and DC plans

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## ➤ **Administrative expenses:**

- DB plans usually cost less than DC plans, because assets and accounts are pooled
- Employer pays DB plan admin costs
  
- DC plans usually cost more than DB plans, because accounts are maintained individually
- Employee pays all or most of the DC admin cost

# Supplemental defined contribution plans

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Most public sector employees who participate in a DB plan also have access to a supplemental defined contribution plan.

# Popular types of supplemental defined contribution plans

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- 403(b) for teachers and health care workers
- 457 for other public employees, as well as teachers and health care workers

*These plan types are also referred to as TSA's and deferred compensation plans*

# Supplemental defined contribution plans

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- Give participants the opportunity to increase retirement wealth and reduce their tax liability by:
  - supplementing their primary retirement benefit
  - managing and investing their contributions

## The long-term value of a DB benefit

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- Mary Brown retires at age 65 with an annual pension benefit of \$25,000
- Her life expectancy is 22 years
- There is a 25% chance she will live to age 93
- During the remainder of her expected life, she will collect \$550,000 in pension payments, plus cost-of-living adjustments

## The long-term value of a DB benefit

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- If Mary had a DC benefit rather than a DB benefit, to be assured she can withdraw \$25,000 each year until she reaches age 87:
  - She would need approximately \$325,000 at retirement
  - If she lives to be older than 87, she will deplete her assets
  - Her DC benefit does not protect her from inflation

# Contributions required to accumulate \$325,000

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- Mary would need to contribute \$368 every month for 25 years to accumulate \$325,000
- Assuming an investment return of 7.5%
- Her accumulated amount will be lower if
  - there are gaps in her working life
  - her investment returns are less than 7.5%
  - she takes loans or withdrawals
  - her contributions are less than \$368 each month

# The importance of protection from inflation

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- Half of all females in the US age 65 will live to be at least age 87
- One-fourth of all females in the US age 65 will live to be at least age 93
  
- Half of all males in the US age 65 will live to be at least 82
- One-fourth of all males in the US age 65 will live to be at least age 88

# The eroding effect of inflation

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- With inflation rising each year at 2.5%
- The purchasing power of \$25,000 will be reduced to
  - \$19,408 after 10 years
  - \$15,067 after 20 years
  - \$11,697 after 30 years

# The importance of protection from inflation

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The cost-of-living adjustment feature in your DB plan protects you against the loss of buying power from inflation

# In Review

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- A defined benefit plan provides a steady and reliable source of income that can protect participants from inflation in retirement
- A DB plan is an effective tool for employers to recruit and retain quality employees
- A supplemental defined contribution plan enables employees to increase their retirement savings and to manage a portion of their retirement assets

# Questions about your pension benefits?

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