Basic Characteristics of Defined Benefit and Defined Contribution Plans

	Defined Benefit (DB)	Defined Contribution (DC)
Purpose	The principal goal of a DB plan is to insure against loss of income in the event of retirement, death, or disability. A DB plan is therefore primarily an insurance program.	The principal goal of a DC plan is to accumulate savings through deferred compensation and investment earnings. The resulting capital accumulation may be used to replace income after retirement or for other purposes. A DC plan is therefore primarily a savings accumulation program.
The Promise	As the insurer, the employer promises to pay a specific benefit in the event of named contingencies, such as retirement, death, or disability. The amount of the benefit is based on pay, age, and service of the member when the contingency occurs.	The employer promises to contribute periodically to each member's individual account. The amount contributed may vary based on pay, age, service, or member contributions. The account balance increased with investment earning until paid.
The Cost	The employer is responsible for contributing whatever the promised benefits cost, net of member contributions, taking into account the investment returns earned by plan assets and other actuarial experience.	The employer is responsible for contributing periodically the amount promised to each member's account.
Benefit Types	Death, disability, and retirement benefits are usually provided. Members who terminated with a vested benefit may be eligible for a deferred retirement benefit.	The account balance is usually payable in the event of retirement, death, disability, or vested termination.
Benefit Eligibility	Age and service requirements are frequently imposed for receipt of death, disability, retirement and termination benefits.	Age and service requirements are frequently imposed for receipt of death, disability, retirement and termination benefits.
Benefit Amount	The benefit amount is determined based on a mathematical formula. The formula usually depends on pay, years of service, and age.	Member and employer contributions are accumulated in an account. The basic plan benefit is the account balance, increased with investment earning.
Form of Benefit	Benefits are usually provided in the form of an annuity, payable for life.	The benefit is the account balance; payable in a lump sum, in installments, or as an annuity for life.
Cost of Living	Annual Cost of living adjustments may be included in the benefit paid.	The member may elect to convert his account balance into an increasing or variable annuity, which may emulate cost of living protection.
Member Options	The member may pick among various forms of benefit at retirement. Usually the choice is limited to the amount of benefit payable to survivors.	The member may pick among various forms of benefit at retirement: Lump sum, partial lump sum, installments, and annuities are typically offered. In addition, the member often can choose the investment mix of his account during his career.
Availability of Funds	The benefit is not available during active service. Plan loans are not permitted.	Plan loans are permitted in some plans. In addition, hardship withdrawals may be allowed.
Administration	Calculation of benefits requires accurate records of member age, service, and pay at disability, retirement, death or termination.	Periodic allocation of investment earnings requires accurate records of member contributions, withdrawals, and investment choices during each allocation period.

Winners and Losers under Defined Benefit and Defined Contribution Plans

	Defined Benefit (DB)	Defined Contribution (DC)	Win Under
Healthy Retirees	A DB plan will pay benefits to all retirees for life. Retirees who exceed standard life expectancy tables will continue to receive benefits until death, with any cost of living adjustments.	DC plan members who annuitize their account balances at retirement will receive benefits for life. However, members who withdraw their account balances in a lump sum or installments may outlive their benefits.	**DB**
Savvy Investors	Under A DB plan, member benefits are usually not affected by the return on plan assets, although the employer's plan cost is affected.	Under a DC plan, the member's account balance is directly affected by the return on plan assets. Those who direct the investment of their accounts in superior fashion will receive much higher benefits than members who are less successful investors.	**DC**
Retirees in Times of High Inflation	Most DB plans base benefits on an average of a few years' pay just before retirement. This provides inflation protection while active. Retirees are often protected by cost of living adjustments.	Since a member's account balance is based on an entire career of contributions and investment earnings, inflation may erode the value of the account just before retirement. Post-retirement inflation protection is usually not fully provided.	**DB**
Death and Disability Beneficiaries	In line with the insurance character of DB plans, reasonable death and disability benefits may be specified by formula. These benefits usually are based on the pay and service of the member at death or disability.	The member's account balance is usually payable at death or disability. Unless additional death and disability benefits are provided by group term life and long term disability plans, the account balance may be inadequate for members with short service.	**DB**
Career Mobile Members	In a DB plan, most of the cost goes to fund retirement benefits. Terminating members' benefits are usually frozen at termination, so their vested benefits are reduced in value.	In a DC plan, the member account balance can be left to be credited with future investment earnings or can be rolled over to another plan or an IRA. In either case, it will tend to retain its value.	**DC**
Early Retirees	DB plans often include subsidies for early retirement: Retirees prior to normal retirement receive a benefit of higher value than those who leave later.	If a member retires early under a DC plan, his account balance must provide retirement benefits for a longer time. There is no increase in the account balance for an early retiree, and a full actuarial reduction is implicitly applied.	**DB**
Older Members	Since they are nearer retirement, the value of benefits earned by older members under a DB plan is significantly higher than those earned by their younger colleagues.	Contributions on behalf of younger members have longer to work and will build up more accumulated investment earnings than those made on behalf of their older colleagues. In addition, younger members are more likely to terminate before retirement.	**DB**
Career Members	Under a DB plan, members enjoy a promised benefit. Therefore, members experience more security and less risk under a DB plan than under a comparable DC plan. However, the complexities of DB plans confuse the member and act as a deterrent to their appreciation of their benefits.	Under a DC plan, members are exposed to risk: The risks of poor investment performance and living past life expectancy are transferred from the employer to the member. However, the simplicity of DC plans increases their perceived value to the members.	**DB** **DC**
Employers	Once DB benefits are put in place, contributions are determined actuarially, and may fluctuate with investment returns and other actuarial experience. Furthermore, since benefit changes may be legally limited, changes in cost are difficult to achieve.	Employer contributions under a DC plan are more predictable than under a DB plan. In addition, DC plan contributions can be changed appropriate legislation to adapt to current financial conditions.	**DC**
Taxpayers	In comparison with the 401(k) and other plans common in the private sector, public sector DB plans appear generous, even though the members pay a significant portion of the cost.	The financial predictability and control offered by DC plans can result in lower tax burdens.	**DC**
Women	Women outlive men by an average of seven or more years. Therefore, women will receive more benefits under a DB plan than comparably situated men.	According to a recent GAO study, women invest more conservatively than men. Ultimately, this is likely to reduce the value of the accounts under a DC plan.	**DB**

Strengths and Weaknesses of Defined Benefit and Defined Contribution Plans

	Defined Benefit (DB)	Defined Contribution (DC)	Favors
Predictability of Benefits	A DB plan is primarily insurance against lost income due to retirement, death, or disability. A benefit specified by a formula is promised. This formula will precisely specify the benefit based on the age, service, and pay of the member.	A DC plan is primarily a savings vehicle. The benefits from the plan will depend on the employer and member contributions, any member withdrawals, and on investment earnings. Therefore, actual benefits are difficult to predict.	**DB**
Predictability of Cost	The employer is responsible for funding the plans net of member contributions. The actual plan cost is influenced by the investment returns earned by plan assets and other actuarial experience. Therefore, actual cost is difficult to predict.	The employer is only responsible for contributing the amount promised to each member's account. Therefore, the employer's cost is precisely specified.	**DC**
Death and Disability Benefits	In line with the insurance character of DB plans, reasonable death and disability benefits may be specific by formula. These benefits usually are based on the pay and service of the member at death or disability.	The member's account balance is usually payable at death or disability. Since the account may be small for those with low service, additional death and disability benefits may be provided by group term life and long term disability plans.	**DB**
Portability (Termination Benefits)	In the absence of special reciprocal arrangements, the benefit for a terminating member is frozen at termination. It will not keep pace with future member pay increases.	A member's account balance can be transferred to another plan or to an IRA. Even if left behind, it will continue to be credited with investment earnings until retirement.	**DC**
Inflation Protection	Inflation protection may be provided by basing retirement benefits on member pay just before retirement and by providing periodic cost of living adjustments.	A member's account balance depends on the contributions made on her behalf during her entire career. In the event of high inflation just before or during retirement, the value of the member's account may be significantly eroded.	**DB**
Simplicity	DB plans are insurance programs. Accordingly, they are complicated and their operation is difficult to understand.	Members usually understand the benefits and operation of a DC plan far better than a DB plan.	**DC**
Flexibility in Design	The benefit amount is determined based on mathematical formulas. Therefore, reasonable benefit levels may be guaranteed for retirement, death, or disability.	The level of contributions can be specified and changed if legally permitted. However, account balances and benefits will depend on prior contribution levels, investment earnings, and inflation, none of which can be controlled. No retroactive increase in plan benefits possible.	**DB**
Flexibility in Benefit Payment	The member may pick among various forms of benefit at retirement. Usually the choice is limited to the amount of benefit payable to survivors.	The member may pick among various forms of benefit at retirement: Lump sum, partial lump sum, installments, and annuities are typically offered.	**DC**
Flexibility in Funding	The employer is responsible for contributing the actuarial cost of the plan every year. To the extent that such contributions are not made, a liability must be established in the employer's financial statements.	The employer is responsible for contributing the amount promised to each member's account. The contribution promised may be changed for future years if legally permitted. No unfunded liabilities appear on employer financial statements.	**DC**
Mortality Risk	Benefits are usually payable for life. A member cannot out live his pension.	Unless an annuity is purchased at retirement, benefits are payable until the account balance is exhausted. A member may outlive his retirement plan.	**DB**
Investment Risk and Reward	Variations in investment performance do not affect member benefits. The employer bears the risk of poor performance and benefits for superior investment performance.	The employer is responsible for contributing the amount promised to each member's account. The member bears the risk of poor investment performance and benefits for superior performance.	
Availability of Funds	The benefit is not available during active service. Plan loans are not permitted.	Plan loans are permitted in some plans. In addition, hardship withdrawals may be allowed.	**DB**
Administration	Calculation of benefits requires accurate records of member age, service, and pay at disability, retirement, death or termination.	Periodic allocation of investment earnings requires accurate records of member contributions, withdrawals, and investment choices during each allocation period. An error in one member's record can affect the allocation to other members.	**DB**