Understanding Defined Benefit Plans

Description:
This article explains what a defined benefit (DB) plan is and why participating in one can help employees achieve greater financial security.

Synopsis:
A defined benefit (DB) pension plan can offer its participants a lifetime of retirement income security. Regardless of market movements or other economic events, each participant receives a fixed dollar amount periodically for the rest of his or her life. A DB sponsor meets this obligation each year the participant works by setting aside sufficient assets to fund the present value of the future benefits.

Body:

If you are eligible to participate in a defined benefit (DB) plan through your workplace, you have been given an increasingly rare opportunity to help provide for your retirement. A DB plan represents an employer's promise to pay a specified, predetermined amount of money to a retired employee periodically for the remainder of his or her life.

The DB plan was once the primary workplace retirement vehicle for millions of Americans. Unlike a defined contribution (DC) plan -- which allows employees to make contributions to their accounts and direct their own investments -- a DB plan is largely, if not completely, funded by your employer. Your employer maintains all of the investment risk as well. Because the contributions are company directed, the employer is responsible for making sure there is enough money in the plan to pay out your benefit, even if the plan's investments underperform.

In order to receive your benefit upon retirement, most employers typically require that employees work at the company for at least a minimum number of years. This feature is called "vesting." Vesting schedules generally range from three to seven years. Pay close attention to your employer's vesting schedule -- if you leave the company before your vesting period, you could walk away with no benefit. You'll find the vesting schedule and other key information about the plan in a document called the Summary Plan Description (SPD). Be sure to read this carefully.

Another key feature to be aware of is "accrual," or the growth of your benefit amount over time. The amount you are entitled to receive will generally increase the longer you stay with your employer. You will also likely receive a bigger benefit if you wait until your full retirement age (usually age 65) instead of opting for an early retirement (at age 55, for example).

Hybrid Plans: A DB-DC Combination

Some employers offer a type of retirement benefit called a "hybrid" plan. Hybrid plans are defined benefit plans that have many of the same characteristics as defined contribution plans. One of the more popular types of hybrid plans is called a cash balance plan. Like traditional DB plans, cash balance plans are designed to pay employees a specified amount at retirement. But like a DC plan, the funds set aside for each employee are held in an individual account, rather than in a general account for all employees.

One benefit of this setup is that a cash balance plan allows you to easily track your accrued benefit. With traditional DB plans, you are reliant on your employer to provide this information -- usually on an annual basis. Cash balance plans are also portable. If you leave your company, you can generally receive a lump-sum distribution of your vested account balance, which you can move to another qualified retirement vehicle, such as an individual retirement account (IRA) or to your new employer's retirement plan.

Benefits Calculation and Payment

The retirement benefits you accrue under a defined benefit plan are based on a formula that takes into consideration many factors, including life expectancy, current and future earnings, and years of service with the company. Some defined benefit pension plan formulas may reduce pension benefits by a percentage of the amount of Social Security benefits you can expect to receive.

Depending on your employer, you may be given several options on how you want benefits to be paid when you retire (benefits from traditional DB plans cannot be taken earlier than age 55). Some common payment options include:

- **Single life annuity:** This option allows the retiree to receive a fixed monthly benefit that stops once the retiree dies. A surviving spouse or other beneficiaries are not entitled to further benefits.
- **Qualified joint and survivor annuity:** Under this option, the retiree receives a fixed monthly benefit as with the single life annuity. However, upon death, the retiree's surviving spouse will continue to receive benefits, either in full or at a reduced percentage until his or her death.
- **Lump-sum payment:** Under this option, the retiree receives a lump sum in full upon retirement. In this option it is up to the retiree to find a suitable income-generating investment to supply fixed payments.

The payment options for your plan are another key feature you'll find in your plan's SPD. It is important to consider all of your options carefully, and compare the benefit payment amounts under each option. You should also inform your employer if you experience any signficant life events, such as marriage or divorce, as they could impact your benefit and related options.

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