# The Value of Defined Benefit Plans

## Executive Summary

Defined benefit (DB) and defined contribution (DC) plans are both components of a broad examination of retirement security. However, there are a number of distinct differences between these types of retirement plans. The American Academy of Actuaries' Pension Committee has created an issue brief to discuss these differences, what they mean to long-term retirement goals, and ways to achieve parity between DB and DC plans.

Defined benefit plans specify the benefit employees will receive when they retire from employment. Defined contribution plans specify the contribution the employer pays into the plan each year for the employee. Hybrid plans, such as cash balance plans, are DB plans that have DC elements.

**Advantages of DB plans versus DC plans for employees**

Defined benefit plans provide retirement security through predictable lifetime incomes for retirees, no matter how long they live. The issue brief discusses, in detail, how DB plans are effective at reducing the different types of risk for employees, including: investment risk, longevity risk, inflation risk, contribution risk, leakage risk, disability risk, survivor risk, early retirement risk and company solvency risk.

DB plans also have been more efficient at investing one large pot of funds, which means they can fund larger benefits with the same contribution, or the same benefit with a smaller contribution.

**Advantages of DB plans versus DC plans for employers**

Defined benefit plans can be as flexible and creative as their designers want them to be. Employers have some flexibility in the amount of contributions they make to DB plans each year – in good years they can put in more so that in tough years, they can put in less. They also have more flexibility with investments and design of the DB formulas.

In addition, DB plans can help employers better manage their workforce. Incentives, such as early retirement windows, can assist in mitigation of the negative financial effects of workforce reductions on employees. And, DB plans can provide incentives that allow employers to better recruit and retain employees. When communicated well, DB plans are more effective in reducing retirement fears among older employees because DB pension benefits can be more predictable.

**Advantages of DB plans versus DC plans for the nation**

There are several advantages, in general, of DB plans as compared to DC plans: generally, a higher percentage of an employer's workforce is covered in a DB plan than in a 401(k) where the employee's contribution is voluntary; the trillions in DB assets promote national saving, economic efficiency and can reach certain investment markets that 401(k)s cannot; DB plans reduce the nation's dependence on Social Security and other government assistance programs; and lifetime pension benefits from DB plans are more likely to help reduce poverty rates for the elderly.

**Achieving parity between DB and DC plans**

At one time, DB plans covered 40 percent of the workers in the U.S. Now, they cover less than half that percentage. The disparity in treatment of DB versus DC plans set by law has contributed to this decline. This issue brief discusses in detail a number of the rules that create a disadvantage for DB plans.

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