

# THE SEARCH CONTINUES:

## Defined Benefit vs Defined Contribution

Some call it a profession. I think of it more as a calling. Destiny makes some of us painters, ball players or police officers. Me? I am an actuary. The excitement, the intrigue, the mathematical accuracy. You won't find a combination like this anywhere else. "Ask an Actuary," that's my motto.

It had been 4 weeks since her last call, and I was closing out the files when the phone rang. I was thinking about rolling it into voicemail, but it was a slow day and I had already been through the latest trends in mortality. I wiped the graphite from my hand and lifted the receiver. The clock read 1:03 P.M. "Ask an actuary," I intoned. If you have a motto, you might as well get some use from it. She started talking immediately. "The Board is meeting next week. The agenda is being mailed tonight. I need to know which is better, a defined benefit plan or a defined contribution plan, and why." I told her that I was on the case and would be there before 2. Another government agency with a retirement problem. Some guys get all the breaks. I tossed an extra set of calculator batteries into my briefcase as I walked out the door. This could be a tough assignment.

My gray Volvo moved at the limit over the bridge, as I thought back to our last discussion. She had been told to switch her agency's retirement program from its current form, a standard final-pay defined benefit plan, to a defined contribution plan. The reason -- cost savings. After a quick investigation, we knew she was looking at the wrong reason to make the switch. They wouldn't get more retirement benefits for less money. In the last few weeks, she had been promoted. This time, she was told to look at the big picture. We had less than 4 hours to put an agenda item together. You've got to love this job. At 1:55 P.M. I walked into her office.

### ***Basic Types of Retirement Plans***

"I've done a little studying since last time," she volunteered in her distinctive high soprano, "and I think we can finish this up in about an hour. It's pretty clear that defined contribution plans are better than defined benefit plans. They're becoming a lot more popular in the private sector. We just need to explain why and show how they will work at our agency."

We'd been down this road together before. She knew that she could get me excited by discussing retirement plans. I grabbed a black pen, made sure that it went with the dry erase board, and wrote "Defined Benefit (DB) versus Defined Contribution (DC)" at the top. I then wrote headings for two columns at the far right labeled "DB" and "DC." The smell of the pens got my mind back to our deadline. I had to limit the parameters for our discussion. "Since we don't have much time, let's stick to traditional defined benefit and defined contribution plans. A traditional defined benefit plan pays a monthly amount determined on the basis of the employee's service with the agency and pay level at retirement."

"I remember from our last discussion," she said coolly. "Contributions are made by both the employee and the employer. The employer guarantees there will be enough money to pay for the benefit. If it costs more than we expect, the employer has to pay more. If it costs less, the employer gets a break."

She knew her DB plans. I tried the DC side. "A traditional defined contribution plan allocates a percentage of each employee's pay to an account each year. The employee often gets to decide how the account is invested." Without missing a beat, she chimed

in, "The employee is making the decisions, so the employee takes the risks. If the investments do well, the employee has a nice retirement. If the investments don't do as well, the employee is forced to work for a few more years. Either way, the employer's contribution is fixed."

She had been studying. "Did any of these articles explain why defined contribution plans were becoming so popular?" I said as I sat down.

### ***Employee Understanding***

"Two reasons," she said, lifting the blue pen and writing on the board. "First of all, they are easier to understand. They work just like a bank account. Most of my employees have had savings accounts since they were kids. They can see the amount of money that has built up." She wrote *1. Employee understanding*, and put a checkmark under the DC column.

"You're right," I agreed. "The defined contribution concept is generally easier for employees to grasp than the defined benefit concept. Employees know how much their annual accrual into the DC plan is worth. They can see it on their statement. They have a tougher time determining the value of a monthly benefit that may not start for 30 years."

"Remember, though," I added, before she could finish her smile, "employees in a defined contribution plan have to understand enough to invest their money. The trustees take care of that in the DB plan."

"It's extra homework for the employees," she responded, "but I still believe they will better understand how a defined contribution plan works."

### ***Recruitment***

"Second," she continued, "today's workforce is more mobile than in the past. Employees are less likely to spend their entire career working for us. This type of employee does better under a DC plan." Her confidence was rising faster than a helium balloon at a birthday party. The blue pen marked *2. Mobile workforce*. She put the second checkmark under the DC heading.

I wanted to keep her talking, but I had to get us on the right track. "With a mobile workforce, there are two key issues from an employer's perspective: getting them to work for you (recruitment) and keeping them working for you (retention), and one major issue from an employee's perspective: portability," I interjected. "I think we should deal with each of those separately."

"Okay, let's start with recruitment," she countered. She quickly changed the heading on the board to *2. Recruitment*. "When we recruit young people, they don't ask about our retirement plan. All they want to know is the work they will be doing, the hours they will work, and the amount of money they will be paid. If we put money into a defined contribution account for them, they look at it as money they can spend when they leave. That's what they want."

"Is it the same when you recruit a senior manager?" I asked. "Not a chance," she responded. "The senior people are very interested in all of our benefit programs. In fact, the more senior the people, the more interested they are in the retirement program."

Faster than you can say "major revision to the Internal Revenue Code," I placed the words *Younger employees* and *Older employees* on the board. She marked an X under

DC across from the words "Younger employees," and an X under DB across from the words "Older employees."

## ***Retention***

Her Casio signaled the top of the hour. She glanced at it and quickly scribbled Retention, next to the number 3. "Doesn't retention work the same way as recruitment?" she asked. "We retain younger people with DC plans and older people with DB plans."

"It can," I said. I could sense this trail leading off in the wrong direction. Like a bloodhound, I moved us toward our quarry. "Let's try taking a slightly different look at it. You put different categories of employees through different levels of training, don't you?" "That's right", she responded, "our police officers and fire fighters go through intense training during their early years on the force. What does that have to do with their retirement plans?"

"Your agency is spending a lot of money to train these officers," I responded, taking the next step. This time, she followed like Ginger Rogers in Flying Down to Rio, "Yes, we are. And once they have gone through the training, we'd like them to stay through retirement."

"Not all employees get that level of training, do they?" I could feel us getting closer. "Of course not," she said. "Our secretaries probably get better training from the temporary agency we hire them from than they do from us."

One final curve, and we would be there. "Why don't you give them better training?" I asked. "I'd like to," she offered, "but we have a tight budget, and I've got a stack of resumes 10 inches high with names of people who are fully trained to do the job. We don't need to train new people."

"So," I said, grabbing a brown marker that looked new, "if you have an employee group with a low replacement cost..." She had the scent. "...it's better to go with a DC plan, if they get any plan at all. And if there is a high cost for training, recruiting, or keeping the position empty, we want a retirement plan that rewards longevity, like a DB plan."

I almost cracked a smile, but remembered that I had a disclaimer to state. "That's right, but remember, retirement plans don't work alone. They are one piece in your total compensation puzzle. If you want to recruit or retain good employees, you need to have all of your programs working together."

## ***Portability***

"Portability is next," she said, drawing the number 4 followed by the word *Portability*. "OK," I said, "we'll call a benefit fully portable if you can move from one employer to another and get the same total benefit." She liked the definition.

"This one should be quick," she said. "You can't get much more portable than a defined contribution account. You transfer the money from one employer to the other and you're done." She moved to put the X in the DC column.

"What about DB plans?" I asked. "You didn't lose any benefit when you came to work here." She froze while she thought about it. "When I was hired from that county down south," she started, "I was told that we had reciprocity. That's one type of portability."

"If there is a reciprocity agreement in place between the system that you are in and the system that you left, and you meet certain requirements, your benefit under both of

those systems will be calculated using your final pay from the agency you are currently working for." Slowly, I moved toward the board and I kept talking. "The downsides to reciprocity are the limited number of agencies that have reciprocal arrangements, and the restrictions when you move. Where do you hire most of your employees from?"

She answered thoughtfully. "We used to hire all of our people right out of school, or from another government agency in the state. That's still where most of our employees come from. Each year, though, a larger proportion of our new hires come from out of state or from the private sector."

I marked three new subheadings: public to private sector, state to state, and within state. "There are no reciprocity agreements between public systems and private sector plans," I said as I marked an X in the DC column. "Although a number of states have discussed the topic, I don't know of any reciprocity agreements that go across state lines." I marked an X under DC in that row. "Even within the state, not all agencies have reciprocity." I put an X under DC in the last row.

"Most of the employees we hire are covered by these agreements," she said, putting an additional X under DB. I think the Board needs to know that this is an area where they might be able to do something."

## ***Flexibility***

"What's next on the list?" she asked impatiently. The clock was moving toward 5. "The last big issue is flexibility", I said. "What do you mean by flexibility?" she quickly countered.

It was getting late. I would have to take this one quickly. "Your defined benefit plan is more than just a retirement plan." She looked as lost as a kangaroo in a New York City subway. This wasn't a good start.

I kept going. "Don't you pay death and disability benefits from the retirement system?" I asked. She nodded. "Our police officers and fire fighters are out risking their lives every day," she volunteered. "We want them to focus on our community's security, and not worry about their family's financial security. A solid death and disability program is a major piece in providing that security. What kinds of death and disability benefit are paid under a traditional defined contribution plan?" "In a traditional DC plan," I answered, "the plan pays out the account balance when the employee becomes disabled or dies."

This didn't seem to satisfy her. "So if a young, short-service employee becomes disabled..." She was looking for an answer. I gave her one. "There will only be a small benefit available from the plan. Many employers with defined contribution plans also have long-term disability plans that provide for these employees." "That's an outside cost to add to the DC side," she said as she scribbled in her note pad.

"You've also used the DB plan to help in strategic workforce reductions." I was trying to find the appropriate words. She found them. "You mean that golden handshake program back in 1994? It did help, but I'm not sure that I like using retirement system assets for that purpose." "Well," I said, "you wouldn't have that option with a defined contribution plan."

She placed the X next in the DB column. "I think we've hit the major issues," she said as she pushed a button on her desk.

## Summary

My time was up. The door opened. A woman entered. She had brown hair. Wore a blue dress. We asked her to copy the notes and prepare them for the Board meeting. It was 4:30 P.M. Not bad for an afternoon's work.

The table looked like this:

<b>Defined Benefit (DB) versus Defined Contribution (DC)</b>		
<b><u>Issue</u></b>	<b><u>DB</u></b>	<b><u>DC</u></b>
1. Employee Understanding		X
2. Recruitment		
— Younger employees		X
— Older employees	X	
3. Retention		
— Low replacement cost		X
— High replacement cost	X	
4. Portability		
— Public to private sector		X
— State to state		X
— Within state	X	X
5. Flexibility	X	

"Six to four," she said, tallying up the score, "So DC plans are better."

"It depends on your objectives," I reminded her. "If you have an easily interchangeable workforce of young people, a DC plan fits. If you are hiring a number of senior people in a high risk area, a DB plan is a better fit."

"What if we are looking for a combination of these for different employee groups?" A good question, but her time had run out.

"Then you may need to have a combination of the two types, or a hybrid. Remember," I said as I packed my briefcase, "we only touched on the basic types of plans and the most basic issues."

"What should I tell the Board about hybrid plans and combinations?" she asked. "Tell them to ask an actuary," I answered. I guess it wasn't such a bad motto after all.

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