Defined Benefit Plans

A Vital Component for a Stable, Secure Retirement

CHRISTIAN BROTHERS SERVICES

Table of Contents

4 Funding a Stable, Secure Retirement

Ideally, an employee's retirement income should stem from a variety of sources. The "Three-Legged Stool" analogy helps to explain the primary sources of retirement income.

5 What is a Defined Benefit Plan?

A defined benefit plan is an employer-funded source of retirement income from which employees are provided the option of a fixed, monthly sum throughout their retirement.

6 Advantages of a Defined Benefit Plan

A defined benefit plan gives an employee a solid foundation for retirement that is not market dependent, allowing the employee to plan for retirement income with greater accuracy, while providing employees with reliable lifetime income.

7 Potential Drawbacks of a Defined Benefit Plan

There can be drawbacks to a defined benefit plan, the most significant of which is the need for the employer to assume all the financial risks associated with the plan.

8 Repercussions of Eliminating or Freezing a Defined Benefit Plan

Freezing a plan does not get rid of an organization's obligations to the plan and it can potentially lessen the organization's ability to fund another type of retirement vehicle.

9 How Do Defined Contribution Plans Differ from Defined Benefit Plans?

In defined contribution plans, the final benefit is not known, but the contribution is. It comes in a designated amount from the employee and/or employer, to an employee's personal account within the plan and invested usually based on the employee's election.

10 Is a Defined Benefit Plan Right for your Organization?

Organizations that are considering maintaining a defined benefit plan should conduct a thorough review of its situation to help ensure plan continuation will be successful and review all possible alternative options.

11 Conclusion

To choose the right retirement plan, organizations need to weigh a variety of factors, one of the most crucial being their goals for the plan.

Christian Brothers Services
Defined Benefit Plan
White Paper

All rights reserved.
cbservices.org

Private sector and nonprofit employers today face a difficult balancing act of wanting to provide a safe and secure retirement benefit for employees without unduly taxing their budgets. Offering only defined contribution plans such as 401(k) and 403(b) plans may seem like an easy and less risky proposition, but is it the best way to get employees to a comfortable retirement?

Putting the responsibility for funding their plans on employees who may have little or no retirement planning experience can be a risky proposition at best and can make retirement a difficult, if not impossible, dream for many workers. Not only does an employee need to figure out how to save enough while employed, they also need to figure out how to spend the money in retirement to ensure it lasts throughout all the retirement years. From an employer perspective, employees may have to delay retirement.

Because of a myriad of retirement funding options, organizations are often unsure of the best approach to practically and appropriately meet employee needs. So what is today's employer to do? In addition, for employers in Catholic organizations, there is another important question. Employees of Catholic organizations have dedicated themselves to working in faith-based institutions. These employees often sacrifice higher salaries elsewhere to be part of a larger, value-oriented mission. Do the employers of these loyal workers have an added moral responsibility to see that their employees are taken care of in their retirement years?

Funding a Stable, Secure Retirement

The "Three-Legged Stool" analogy helps to explain the primary sources of retirement income. Preferably, an employee's retirement income should stem from a variety of sources, including but not limited to the following "legs" of the stool:

- *Employer-funded vehicles such as defined benefit plans (pensions) and employer contributions to a defined contribution plan*
- *Employee-funded vehicles, including defined contribution plans (401(k), 403(b), etc.) and personal savings accounts*
- *Social Security benefits, which are employee and employer funded*

A combination of these channels can ensure retirement income stability even if one element in the group fails to deliver as expected. For example, if a poor economy reduces the rate of return for employee savings plans, an employer-funded option and Social Security can still generate significant retirement income.

Unfortunately, in the coming years, we believe Social Security will replace a smaller percentage of pre-retirement earnings. With the Social Security Retirement Age now ranging between age 65 and 67 based on your year of birth, those who choose to retire at 65 or earlier will see a cut in their monthly benefit relative to pre-retirement earnings. According to the U.S. Social Security Administration, for those retiring at age 65, Social Security will replace only 36 percent of income in 2035, down from 39 percent in 2015 and 43 percent in 1995. It remains to be seen if Congress might change other aspects of the program such as extending the Social Security Retirement Age.

With these shortfalls projected with Social Security benefits, employer- and employee-funded savings plans will be essential to make up possible shortfalls and ensure employees have a stable retirement.

What is a Defined Benefit Plan?

A defined benefit plan is an employer-funded source of retirement income from which employees are provided the option of a fixed, monthly sum throughout their retirement. Unlike other retirement plans, including defined contribution plans, an employee does not normally contribute any money to a defined benefit plan but relies on the employer to fund the plan appropriately. Their right is not to an account balance, but to elect a stream of payments upon retirement. Employers assume all the investment risk and thus protect their employees from unstable market performance.

In a defined benefit plan, benefits can be distributed in many ways upon the employee's retirement, depending on the preference of the company. To receive full benefits, the employee will have to be with the company for a certain number of years, known as the "vesting period." Employees can receive their benefit payments periodically (monthly, quarterly, etc.), in a lump sum, or a combination, for the rest of their lives. If the employee chooses a joint and survivor annuity upon retirement, the retiree will receive a reduced monthly benefit for life. Once the retiree passes away, the joint annuitant will receive benefits of a certain percentage such as 50% or 100% of the retiree's monthly benefit, depending on the election chosen at retirement, until their passing.

Advantages of a Defined Benefit Plan

As previously mentioned, a defined benefit plan protects employees from risks associated with fluctuating markets. Since employers assume the investment risk, employees receive a specified monetary payment regardless of investment returns. This gives an employee a solid foundation for retirement that is not market dependent, allowing the employee to plan for retirement income with greater accuracy.

Defined benefit plans also shield employees from longevity risks. A defined benefit plan pays the employee each month for the length of his or her lifetime, regardless of how long the individual may live, thus securing income across retirement. Employees can also plan to retire sooner. Department of Labor statistics show employees whose primary retirement plan is a defined benefit plan tend to retire one to two years earlier, on average, than employees covered only by a defined contribution plan. Defined benefit plans typically provide for the continuation of payments for a spouse in the event of the employee's death.

In addition to protecting employees from investment and mortality risks, a defined benefit plan removes the burden of financial decision-making and investment monitoring from employees, allowing for professional management that better controls investment performance over the life of the plan. Studies show that investment results from professionally managed defined benefit plans outstrip those of managed defined contribution plans, thus affording employees a greater retirement benefit. Also, defined benefit plans can incorporate more diverse investment vehicles, such as alternative investments and real estate, which could yield potentially higher investment returns with less risk. Most defined contribution plans have more limited investment options. Also, due to their larger asset values, defined benefit plans meet the breakpoints of investment managers which lowers investment costs.

Compounding the advantages for employees that defined benefit plans provide, there are some intangible benefits for employers as well. For example, these plans can be thought of as a reward for employees who may have sacrificed higher wages from the private sector and decided to make a long-term commitment to a church organization. Because employees of Catholic organizations often make sacrifices in terms of larger salaries in order to serve the Church, offering a defined benefit plan is an appropriate way to "give back" to the employee and acknowledge his or her sacrifice. The concepts of "giving back" and providing for those who need it—in this case employees—fit with the tenets of the Catholic Church and its mission.

A defined benefit plan can also be an attractive part of a comprehensive benefits package for employees. Since individuals take into consideration the scope and nature of an employer's benefits portfolio before making decisions about employment, having a benefits package that includes a defined benefit plan is useful for attracting and retaining employees over time.

Potential Drawbacks of a Defined Benefit Plan

There can be drawbacks to a defined benefit plan, the most significant of which is the need for the employer to assume all the financial risks associated with the plan. The toughest task in retirement planning is funding. Someone—employer or employee—has to set aside money for the future. Companies offering a defined benefit plan must be able to make adjustments to funding levels when necessary. While a funded pension is a benefit to the employee, these funding adjustments present a challenge for the employer. A portion of the funding for the plan must come from investment returns, and this has a direct impact on the second portion of the funding, which is employer contributions. As previously mentioned, defined benefit plans can be difficult to fund during financial downtimes, and unlike a defined contribution plan where the employer can suspend an employer match or contribution at any time, an employer must maintain contributions to a defined benefit plan regardless of the market.

For employees, a drawback can be their age and whether they will fully realize the advantages of a defined benefit plan. For younger employees, these advantages may be hard to see as an employee must remain with an organization for an extended period before the value of the benefit equals or surpasses that of a defined contribution plan. Staying with one employer for a long period of time isn't the norm today. According to the Bureau of Labor Statistics, the current average American worker will have held 10 jobs by age 40.

For organizations with high employee turnover, a defined benefit plan may not make sense, as it offers little advantage to short-term employees. For example, those employees who work three or four years and then leave for another job will walk away with nothing from the defined benefit plan, since most defined benefit plans use cliff vesting[1]. Most defined contribution plans use graded or immediate vesting[2].

Even if they become vested and then leave shortly after, these employees will come away with a small monthly income at retirement. Unlike a defined contribution plan which can be "rolled over" into a new employer's plan or individual retirement account, a defined benefit plan cannot be transferred unless the defined benefit plan offers a single sum option.

[1] Cliff vesting is when employees earn the right to receive full benefits from their retirement plan at a specified date, rather than gradually over a given period of time. An example of cliff vesting is when an employee becomes fully vested after five years of full-time employment.

[2] Graded vesting is when employees gain the right over time to permanently keep employer contributions made to the employee's retirement account. For example, in a five-year graded vesting schedule, an employee might gain the right to 20% of the employer's matching contributions in the first year, 40% in the second year, and so on until he or she is completely vested.

Repercussions of Eliminating or Freezing a Defined Benefit Plan

At a future time, if an employer struggles to fund a defined benefit plan, the topic of eliminating or freezing a current plan could arise. While initially this may seem to be an effective way to cut costs and save money, there are some negative consequences to this kind of action. Not only will freezing a defined benefit plan severely curtail an employee's retirement income, it breaks a commitment with the employee. The employees of Catholic organizations rely on those organizations to respect their mission in all operations, even employee management. Freezing or eliminating a defined benefit plan can run contrary to an organization's mission and should be avoided if at all possible.

In addition, freezing a defined benefit plan may not be the financial boon some organizations expect. Freezing a plan does not get rid of an organization's obligations to the plan and it can potentially lessen the organization's ability to fund another type of retirement vehicle. Freezing a defined benefit plan is like owning a house that you don't live in anymore, but you continue to pay the mortgage, taxes, and upkeep. This could tie up funds that could be used to provide other employee benefit options.

How Do Defined Contribution Plans Differ from Defined Benefit Plans?

Over the past 40 years, many for-profit companies have shifted from defined benefit plans to defined contribution plans. This has simply changed the risk from employers to employees; Church organizations need to assess who is better prepared to understand these risks.

In defined contribution plans, the final benefit is not known, but the contribution is. It comes in a designated amount from the employee and/or employer, goes into the employee's personal account within the plan and is invested based on the employee's election within the plan. As investment results are not predictable, the ultimate benefit at retirement is undefined, but the employee owns the account itself and can withdraw or transfer the fund within plan rules.

Although they were originally meant to complement defined benefit plans, defined contribution plans have instead overtaken and, in most cases, replaced them. With this change in how people are saving for their retirement, much of the obligation for funding employee retirements has shifted from the employer to the employee. Today's workers without access to a defined benefit plan bear the responsibility of how to fund their retirement plans, making sure investment levels are adequate to and through retirement, as well as monitoring the fees they are being charged.

Getting workers to participate voluntarily in defined contribution plans can be a tough obstacle for employers to overcome. These plans rely on employee participation to adequately fund their retirement income. Even individuals who participate and fund their plans sufficiently are susceptible to making mistakes such as withdrawing their retirement savings during market downturns, misunderstanding the investment risks, or running out of money in retirement.

Defined contribution plans are an important part of retirement income adequacy. But defined contribution plans without employer contributions and/or a defined benefit plan are missing a key component of the "Three-Legged Stool" analogy.

A defined contribution plan will only provide monthly income until the account is depleted. If an individual has $200,000 in his or her defined contribution plan when retirement begins, he or she may run out of money before passing away. If the employee retires at age 65 and lives until age 90, for example, the money needs to last 25 years in retirement, which could exceed the number of years the employee worked. Organizations should note that the government is encouraging defined contribution plans to provide an annuity option–making them more similar to defined benefit plans. However, purchasing an annuity is substantially more expensive than providing this benefit in a defined benefit plan.

Is a Defined Benefit Plan Right for your Organization?

Like any benefit plan implemented for employee retirement planning, defined benefit plans bring challenges, but they are not insurmountable. An organization sponsoring a defined benefit plan should routinely review its situation to help ensure the plan continues to meet the organization's goals:

- *Assess your organization's current retirement savings plan(s) from both the employer and employee perspective.*
- *Consider changes that reflect your organization's vision for providing retirement benefits.*
- *Communicate to employees about your organization's retirement savings philosophy and approach. By performing a simple survey of the employees they wish to retain and/or reward, organizations may find commonalities that can help them narrow down the attributes to look for in a plan.*

There are key activities in which organizations can engage that will improve the efficiency of the plan and make it more practical long term. Such activities include:

- *Increasing the normal retirement age*
- *Reducing the benefit formula prospectively*
- *Merging with an existing plan to achieve economies of scale*
- *Changing the vesting schedule*

A combination of these activities can turn a plan from a drain on organization funds to a manageable commitment for employee retirement.

The more proactive an organization is in designing a defined benefit plan, the better the plan can weather changing market pressures. Organizations may want to establish trigger points—such as a certain funded percentage—that launch a close examination of the plan's various components. This allows the organization to respond quickly to changes before they negatively impact the organization's ability to support the plan. Being proactive can also prevent the organization from overreacting with drastic changes during times of crisis, thus ensuring a plan that is consistent and practical for the long term.

Conclusion

To choose the right retirement plan, organizations need to weigh a variety of factors, one of the most crucial being their goals for the plan. In order to attract, retain, and reward employees, helping to provide them with a stable, secure retirement should be at the top of the list of goals. The more an organization knows about the nuances of defined benefit plans, the better they can tailor their plan to meet the unique needs of employees as well as the organization.

Defined benefit plans are designed to help employees experience a financially sound life during their retirement years. Organizations that understand how to appropriately manage their defined benefit plan and its funding requirements are in the best position to ensure the plan is affordable, practical and appropriate, well into the future.

About the Authors

Brother Michael Quirk, FSC, Ed.D.

Brother Michael Quirk is the President/CEO of Christian Brothers Services, a Lasallian enterprise which serves Catholic institutions and organizations by administering and managing employee health benefit and retirement plans, religious health trusts and institutional risk management services. Prior to joining CBS, he was the President of De La Salle Institute, a co-institutional secondary school in Chicago for 20 years.

Brother Michael holds a MBA from Lewis University and a doctorate in Education from De Paul University. He presently serves on the boards of various Lasallian institutions: Montini Catholic High School, San Miguel School-Chicago, Saint Mary's University in Minnesota, Christian Brothers University and Saint Mary's Press. In addition, he is the President of the Extollo Educational Foundation, Chair of the Lasallian Education Fund and a member of the Church Alliance. He is a former member of the Chicago Board of Ethics and former president of the Catholic United Investment Trust.

Karen Herba

Karen Herba has been providing retirement consulting for over 30 years and joined Christian Brothers Services in 2015 as the Director of Retirement Services/Plan Consultant. In 2021 Karen was promoted to Managing Director of Retirement Planning Services. Retirement Planning Services (RPS), functions as the administrators of the Christian Brothers Employee Retirement Plan (CBERP), the Christian Brothers Retirement Savings Plan (403b Plan) and the Christian Brothers Employee Retirement Savings Plan (401k Plan). RPS provides world-class support and client assistance to over 1,000 Catholic organizations and over 40,000 participants.

Karen is an Enrolled Actuary, an Associate of the Society of Actuaries and a member of the American Academy of Actuaries.

Jim Ceplecha

Jim Ceplecha has 37 years of experience working with Catholic organizations, with the last 29 of those years overseeing the defined benefit and defined contribution plans for Christian Brothers Services. In 2021 Ceplecha transitioned to his new role of Executive Director, Defined Contribution (DC) Plans at Christian Brothers Services.

He is a Fellow in the International Society of Certified Employee Benefit Specialists, a board member for the Diocese of Joliet Priests Retirement Plan and the chair of the Church Benefit Association's Retirement Planning Group.

Contact:
Karen Herba
Managing Director of
Retirement Planning Services
Karen.Herba@cbservices.org
800.807.0700 x2634

CHRISTIAN BROTHERS SERVICES