Defined Benefit Plans

A Critical Element in Employee Retirement Planning

CHRISTIAN BROTHERS SERVICES

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Defined Benefit Plans

A Critical Element in Employee Retirement Planning

In today's fluctuating economy, employers in both the private sector and nonprofit world are searching for effective methods to provide a safe and secure retirement benefit for employees without unduly taxing the budget. Because of a myriad of retirement funding options, organizations are often unsure of the best approach to practically and appropriately meet employee needs.

Ideally, an employee's retirement income should stem from a variety of sources, including but not limited to the following:

- *Employer-funded vehicles such as defined benefit plans*
- *Employee-funded vehicles, including defined contribution plans (401(k), 403(b), etc.) and personal savings accounts*
- *Social Security*

A combination of these vehicles 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. With the shortfalls projected with Social Security benefits, employer- and employee-funded savings plans will be essential to make up possible shortfalls.

Unfortunately, many employers are shying away from employer-funded options such as defined benefit plans, considering them too onerous and outdated. With pressure to reduce expenses, a number of organizations have eliminated or frozen existing defined benefit plans in order to save money.

There are several advantages to offering a defined benefit plan as well as several disadvantages to freezing one. Organizations should fully understand and appreciate the nuances of this type of vehicle before making any long-lasting decisions.

What is a Defined Benefit Plan?

A defined benefit plan is an employer-funded source of retirement income from which employees are provided 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. Employers assume all the investment risk and thus protect their employees from unstable market performance.

Over the past 20 years, defined benefit plans have been losing favor with many businesses in the corporate sector. The Employee Retirement Income Security Act (ERISA)—a federal law that regulates pension plans in private industry—and subsequent legislation have imposed detailed requirements on various aspects of plan administration, including participation, vesting, benefit accrual, and funding. One particularly stringent requirement relates to plan funding. The law precludes a corporation from contributing to a defined benefit plan when the plan is significantly overfunded and mandates a minimum contribution when the plan is not. As a result, corporations cannot contribute "extra" money to a pension plan during economically fruitful times to anticipate economic downturns. Conversely, in challenging times, corporations are forced to make a minimum contribution to the plan—sometimes to the tune of millions of dollars. Rather than face the volatility inherent in pension plans, corporations are contemplating freezing or terminating these investment vehicles.

Fortunately, "church plans" are not required to comply with ERISA regulations. While many such plans voluntarily comply with certain aspects of the legislation, they tend to apply those rules that support the best interests of employees and employers. For example, employers with a church plan must fund the benefits promised to employees but are not subject to the rules requiring funding in difficult times and no funding in good times. Consequently, employers can allocate a steady contribution regardless of the state of the market, enabling more effective and predictable budgeting.

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. In addition, these types of plans typically provide for the continuation of payments for a spouse in the event of the employee's death.

A defined contribution plan, on the other hand, provides funds monthly until the account is depleted. Even if an individual has been able to save as much as $200,000 in his or her defined contribution plan, he or she may run out of money before passing away. If the employee 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. However, purchasing an annuity is substantially more expensive than providing this benefit in a defined benefit plan.

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.

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Advantages of a Defined Benefit Plan

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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

Despite the advantages, there can be drawbacks to a defined benefit plan. Probably the most significant is the need for the employer to assume all the financial risks associated with the plan. While a benefit to the employee, this presents a challenge for the employer. 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.

The age of an organization's employees can also determine whether the advantages of a defined benefit plan are fully realized. For organizations with younger employees, for example, 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.

Similarly, 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 very little 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. This limits earnings if an employee's tenure is relatively brief.

[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.

The Negative Consequences of Eliminating or Freezing a Defined Benefit Plan

As employers struggle to fund defined benefit plans, the topic of eliminating or freezing a current plan inevitability arises. 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. During a recent interview, a Bishop of a mid-sized diocese —who like most Bishops was formerly a parish priest— underscored this point, noting he respects the amount of time people devote to a diocese and feels there is an obligation to consider options other than freezing defined benefit plans. The Bishop added that as stewards of the Church, relieving the uncertainty of retirement for our employees is right and just.

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. For example, if an organization chooses to freeze a defined benefit plan because it has not been able to fully fund the plan—which is often the case—the organization must still make payments to maintain the plan's existing level. This could tie up funds that could be used to provide other employee benefit options, such as an employer match for a defined contribution plan.

Consider the example of a 52-year-old, single mother who worked for 20 years at a small diocese as an administrative assistant. Her salary was enough to cover her living expenses and fund a small savings account. When she was in her late 40s, a personal illness depleted her savings. Despite her condition, she missed very little work time and was devoted to her position at the diocese, feeling she was doing her part for the Church. As the woman approached retirement, she knew she was not able to save much, but was confident she could manage based on her diocesan pension and Social Security.

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The Negative Consequences of Eliminating or Freezing a Defined Benefit Plan

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During this time, the diocese also faced some financial difficulties. After several years of economic hardship, it made a decision to freeze its pension fund and create a defined contribution plan. Because it was still required to make payments into the pension fund to maintain its current level, the diocese had little money leftover and was unable to offer employees a match on the newly created defined contribution plan.

Because the woman was relatively close to retirement, the defined contribution plan was not able to replicate the lost benefits from the defined benefit plan. As a result, the woman had less retirement income than expected and was forced to take an additional job to ensure she had sufficient funds upon retirement. She not only felt betrayed by the organization she worked so long to serve, she also felt the diocese may have violated its own principles of just wage and financial protection in times of financial difficulty.

Overcoming the Challenges of a Defined Benefit Plan

While defined benefit plans have their challenges, they are not insurmountable. In many cases, modifying an existing defined benefit plan can make it work better for an organization. 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 the following:

- *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. Consider the story of a large, Midwestern diocese that faced the challenge of a significantly underfunded defined benefit plan. During a period of economic strength, the diocese increased the retirement benefit for all employees and was not able to fund the increased liability once the economy destabilized. While the organization was committed to keeping the plan, it needed a way to make it economically viable. The first step was to reduce benefits to their previous levels, so as to provide a more realistic liability for the organization. The diocese also extended the retirement age to match Social Security, increased employee eligibility hours, and eliminated the death benefit associated with the plan—except for those employees grandfathered in due to their proximity to retirement. As a result, the diocese now has a more manageable liability and a path forward for funding it. Before making the changes, the diocese was transparent with employees about the need for change and what effect the alterations would have on employees and their retirement income.

The more proactive an organization is in designing a defined benefit plan, the better the plan is able to 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

Fundamentally, organizations that understand how to appropriately fund and manage their defined benefit plan are in the best position to successfully offer this type of plan. The more an organization knows about the nuances, the better they can tailor the plan to meet the unique needs of participants as well as the organization. This will ensure the plan is affordable, practical, and appropriate well into the future.

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