RETIREMENT PLAN COMPONENT COMPARISONS

Retirement plans are generally categorized as one of the following types: defined benefit retirement plans, defined contribution retirement plans, or hybrid retirement plans. Most hybrid plans, including cash balance plans, have been created by adopting selected components of defined benefit plans and defined contribution plans. This memorandum describes components of each type of retirement plan and potential advantages and disadvantages of each type of retirement plan.

DEFINED BENEFIT RETIREMENT PLANS

Defined benefit retirement plans are traditional pension plans that provide a lifelong annuity upon retirement, usually based on final average salary and length of service. Major components of defined benefit retirement plans include:

- Both the employer and employee may be required to contribute, but the benefits are not based on employee contributions.
- The employer, through a pension fund, determines how funds are invested and managed.
- A predetermined formula defines contributions and benefits to be paid out in advance.
- Some plans may include postretirement benefit adjustments, disability and life insurance, and retiree health insurance.
- Some plans may provide cost-of-living adjustments (COLAs).

The calculation used for the defined benefit retirement plan formula is generally an employee's years of service multiplied by a benefits factor multiplied by the employee's final average salary during a specified number of months. The funds in defined benefit retirement plans are controlled by the employer, and any investment risk or any investment rewards are assumed by the employer rather than the employee.

Advantages of defined benefit plans include:

- Guaranteed lifetime income to retired employees.
- More retirement income for career employees.
- Investment management fees are usually lower than defined contribution plans.
- Investment returns, on average, are higher than defined contribution plans.
- Potential inflation protection for employees during career.
- Employer incentive for potential investment gains.

Disadvantages of defined benefit plans include:

- Noncareer employees generally benefit less than career employees.
- Cost of plan can fluctuate each year.
- Benefits are not as portable as defined contribution plans.
- Employer is at risk for potential investment losses.

DEFINED CONTRIBUTION RETIREMENT PLANS

Defined contribution retirement plans provide individual retirement accounts into which both the employer and the employee make contributions and, with accumulated investment returns, provide the basis for a retirement benefit. Major components of defined contribution retirement plans include:

- Employer and employee both contribute to the account.
- Generally, the employee determines how funds are invested (the investment options may be limited to certain indexes or funds as determined by the employer).
- Employer contributions to the account are guaranteed, but not the future benefits.
- Employer and employee contributions are defined and known in advance, but the benefits to be paid out are not known until retirement.

Defined contribution retirement plans are generally established to contribute a certain percentage based on an employee's salary or to match a certain percentage based on an employee's salary in relation to the percentage an employee contributes. At retirement, the balance of the fund is the basis of the employee's retirement benefit. The employer does not guarantee a benefit and usually does not provide postretirement benefit increases or any COLAs. The funds in defined contribution retirement plans are controlled by the employee, and any investment risk or any investment rewards are assumed by the employee rather than the employer.

Advantages of defined contribution plans include:

- Contribution amount is easy to determine, understood, and usually constant.
- More retirement income to noncareer employees.
- Retirement account balances can transfer from one employer to another.
- Costs are fully funded.
- Employee incentive for potential investment gains.

Disadvantages of defined contribution plans include:

- Less retirement income for career employees.
- Benefits are not related to preretirement working pay.
- Employee risks potentially outliving accumulated assets.
- Employee risks potential investment losses.
- Less incentive to retain employees.

HYBRID RETIREMENT PLANS (COMBINATION OF THE TWO PLANS)

Hybrid retirement plans combine elements of defined benefit retirement plans and defined contribution retirement plans. Generally, employees may be eligible for both a defined benefit plan component and a defined contribution plan component, or both components may be mandatory. Employer contributions generally finance the defined benefit plan component to provide an annuity at retirement, and employee contributions accumulate in an individual retirement account under the components of defined contribution plans.

Any formulas for calculating benefits, control of funds, or any investment risks or investment rewards would be based on how the hybrid plan is structured and what components are included from defined benefit retirement plans and defined contribution retirement plans.

Depending on which components are adopted from defined benefit or defined contribution plans, hybrid plans would share similar advantages and disadvantages of these plans.

Advantages of hybrid retirement plans include:

- More flexibility to meet both employee and employer goals.
- More options for employees at retirement, including lifetime payments or a lump sum payment.
- More portable than traditional defined benefit retirement plans.
- Less investment risk to employees than defined contribution retirement plans.
- Less investment risk to employers than defined benefit retirement plans.

Disadvantages of hybrid retirement plans include:

- May be more complicated than defined benefit retirement plans or defined contribution retirement plans.

CASH BALANCE PLANS

Cash balance retirement plans are a form of a hybrid plan. Like defined contribution retirement plans, they provide each employee with an individual retirement account into which both the employer and employee make contributions. Funds in the employee retirement account are pooled for investment purposes, employee balances are guaranteed, and the employee is guaranteed an annual rate of return. Major components of cash balance plans include:

- Each employee has an individual retirement account.
- Employer and employee both contribute to the account.
- The employee does not choose how the retirement funds are invested.
- The employee accounts are all managed in one commingled fund, and employees are guaranteed a specified return on their accounts.
- The employee may receive additional amounts above the guaranteed annual rate of return depending on the actual rate of return on the commingled fund.
- Upon retirement, the employee receives an annuity based on the account balance and may have additional benefit options, including COLAs.

Advantages of cash balance plans include:

- Plan calculation is easy to determine, understood, and usually constant.
- If the employee leaves before retirement, the employee can take a lump sum payment and roll over to an individual retirement account (IRA).
- Employee can choose between a lifetime annuity or a lump sum payment upon retirement.
- Employees are guaranteed a certain rate of return, and may receive additional amounts if the actual rate of return on pool of funds is higher.
- Employer's potential for investment loss risk is limited.

Disadvantages of cash balance plans include:

- Employer is at a limited risk for potential investment losses.
- Employee does not have ability to control the investment of funds.

The following schedule provides a comparison of the major components of each type of retirement plan:

Features	Defined Benefit Retirement Plan	Defined Contribution Retirement Plan	Cash Balance Retirement Plan	Hybrid Retirement Plan
Employer obligation to make payments end	Lifetime of the employee, and perhaps a survivor	Employee's tenure on the job	Employee's tenure on the job	Depends on how the plan is structured
Cost-of-living adjustment	Most plans offer, depending on an actuarial estimation	No	Most plans offer, depending on fund's overall annual rate of return	Depends on how the plan is structured
What employee receives upon retirement	Promise of a fixed monthly payment	A lump sum that may be converted to an annuity or drawn down, as with an IRA	Promise of a fixed monthly payment	Depends on how the plan is structured
Investment control	Employer	Employee acting within limits established by the employer	Employer	Depends on how the plan is structured
Benefit calculation	Years of service, benefit multiplier, final average salary	Percentage of salary deposited over time, with earnings and possibly employer matching funds	Percentage of salary credited to a commingled account, plus an interest rate set by the employer	Depends on how the plan is structured
Does plan reward longevity or mobility	Longevity (generally)	Mobility (generally)	Either	Depends on how the plan is structured
Can employee supplement money contributed by the employer	No (generally)	Yes	No (generally)	Depends on how the plan is structured
At risk or reward for investment gains or losses	Employer	Employee	Employer, but limited	Depends on how the plan is structured