RETIREMENT 101

Difference between Defined Benefit Plans and Defined Contribution Plans

SB cera
San Bernardino County Employees' Retirement Association

People often get Defined Benefit (DB) or pension plans confused with Defined Contribution (DC) or salary savings plans. The two are very different retirement plans in their make-up, return and management. The key difference between the two plans is that in a DB plan the employer assumes the investment risk by agreeing to pay the stated benefit, unlike a DC plan where the employee bears the investment risk. Investment gains and losses do not affect the benefit payable to the DB plan participant. Here are a few quick points to understanding other key differences:

Defined Benefit (DB) Plans

A member's benefit is a predictable lifetime income based on years of service under the plan, retirement formula factor and age.

The majority of public sector DB plans are funded by employee pre-tax contributions and employer contributions which can vary by plan design or actuarial valuation on an annual basis.

Plan benefits are paid to eligible members on a monthly basis and usually provide retirees some type of annual cost-of-living increase to offset loss of purchasing power due to inflation. The benefit is paid until the member dies with some plans offering possible continuances to qualified beneficiaries.

Investments are managed by professional investment staff and Board. If investment returns fall below the assumed rate of return, employers are liable for the additional assets necessary to fund the defined benefit. Therefore, members never have to make investment decisions or have their pension benefit bear the brunt of volatile market activity.

Defined Contribution (DC) Plans include 401(k), 403(b), or public sector 457 plans

A participant's benefit from a DC plan is based on contributions, any employer contributions and investment gains or losses. The life of the benefit is limited to the accumulated balance.

DC plans are funded by employee pre-tax contributions and possibly employer contributions if the plan design allows.

Benefits can be paid from a DC plan in several ways. The most common are monthly payments until all account assets are depleted; a lump-sum payment of account assets; or, a private annuity that pays a monthly benefit for a fixed period.

Investments may be managed by a money manager or investment staff. However, if investment returns are negative, there is no compensation to the participant. Employees drive the investment decisions and need to manage changes to their plan in response retirement goals and possibly volatile market activity.

rev 9/28/21