DEFINED BENEFIT PENSION PRIMER

Providing Retirement Security for Missouri
COMMON PENSION TERMS

**Actuary** - a business professional who deals with the measurement and management of risk and uncertainty

**Actuarial Required Contribution** - the amount an employer must contribute for the year, calculated in accordance with certain parameters in order to fund the liability over time.

**Defined Contribution Plan** - a plan that provides an individual retirement account for each participant with benefits based solely on (1) the amount contributed to the participant’s account plus (2) any income, expenses, gains, losses, and forfeitures. Contributions to the account may be made by the employee or the employer. Defined contribution plans include 401(k), 403(b), and 457(b) plans.

**Defined Benefit Plan** - employee group retirement plan established and maintained by an employer that uses a predetermined formula to calculate the amount of an employee’s retirement benefit. The benefit formula may take into consideration an employee’s years of service and salary during employment. No individual accounts are maintained. Employees and Employer may contribute to help fund the plan.

**Unfunded Actuarially Accrued Liability** - the difference between what a pension system has accumulated in assets (paid in contributions, plus earnings) and what it owes its members in benefits. It’s important to note that the UAAL is never due all at once, but can be paid off over time.

**Vesting** - a period of time in which an employee must work in order to become eligible for his or her retirement benefit. Vesting periods vary from plan to plan.

A DEFINED BENEFIT PLAN

Attracts quality employees

Incentivizes employees to work hard and stay with an employer during their most productive years

Keeps lines of promotion, allowing younger talent to stay and grow within the employer

Provides a dignified exit from the workforce so that employees can retire when they are ready

WHAT IS A DEFINED BENEFIT PENSION?

A defined benefit pension is a type of retirement plan that pays a predictable, lifetime benefit at retirement based upon a person’s working career. The benefit is not based on an account balance, but rather accrued through years of service. Because of this, pensions are a great tool for promoting longevity among employees. Employers use pensions as a tool to attract and retain high quality public servants in the workforce which in turn translates into great public services for our state and local communities!

HOW ARE BENEFITS CALCULATED?

While every pension system is unique, pensions generally use an employee’s years of service and average salary to calculate a predictable, lifetime monthly retirement benefit. Each pension plan will have unique benefit provisions used in calculating individual retirement benefits.
PAYING FOR DEFINED BENEFIT PENSIONS: PRE-FUNDING BENEFITS

Prefunding a pension means that when a member retires, all the money needed to pay for their lifetime benefit is already paid for and set aside. Prefunding not only creates benefit security for plan retirees, but it also helps lower the pension cost to taxpayers because excess investment return drives down employer contributions over time. Pensions are funded through employee contributions, employer contributions, and investment return.

KEYS TO A WELL-FUNDED PLAN

**Making the Contributions**
There is no secret to well-funded pension plans—they all make their full contributions. Fully funding the required contribution each and every year is essential to the long-term health of a pension plan. Just like your mortgage, falling behind on your required contributions not only means you have to make up those payments, but also interest, and those payments can snowball quickly.

**Setting & Evaluating Assumptions**
In order to set aside money for the future, a pension must make assumptions about what they expect to happen in the future. These are called actuarial assumptions. No matter what level a plan sets their assumptions at, assumptions must periodically be re-evaluated to ensure they remain appropriate because over time, economic and demographic conditions can change.

**Adjusting Assumptions Based on Experience**
Once a plan has evaluated its experience, adjustments should be made, when warranted, to the actuarial assumptions to reflect changes in economic and demographic conditions. Adjusting assumptions ensures that the plan will continue to be funded at an appropriate level going forward.

** Setting assumptions too high or too low will ultimately overcharge or undercharge today’s taxpayer for the benefit’s being earned by today’s public workers. That’s why pension plans attempt to set assumptions as close to reality as possible and make slight adjustments on an ongoing basis to reflect changing conditions over time. This ensures today’s taxpayers are being appropriately charged for today’s promised benefits.**

After a lifetime of hard work, pensions are a mechanism that help middle class workers transition into middle class retirees.
PENSIONS ARE AN INVESTMENT IN MISSOURI

Pensions are not just good for the worker receiving them, they are an investment in Missouri and everyone who lives here.

- Pensions are a tool that attract the highest quality workers into public service.
- Great workers = great services for the taxpayers of Missouri.
- Missouri is a more attractive place to live when we have great public services, infrastructure, schools, etc.
- When Missouri’s public servants retire, they take their pension and spend it back in their local communities, providing a great economic reinvestment in our state.

ARE WE MEASURING THE FUNDING SHORTFALL IN INDIVIDUAL DEFINED CONTRIBUTION PLANS?

All retirement plans require the sponsor or individual participant to make assumptions about the future. In a Defined Benefit plan, the plan sponsor sets assumptions for the pooled group of participants. In a Defined Contribution plan, the individual is responsible for making assumptions about their individual market performance, longevity, future contributions, etc. Like in a Defined Benefit plan, failing to set and maintain realistic assumptions about the future may result in an individual funding shortfall for the Defined Contribution plan participant. These individual funding shortfalls may have serious policy implications in the future as more and more individual savers enter retirement without adequate personal savings.

Source: National Institute of Retirement Security

The average U.S. household Retirement Account balance for near-Retirement Households is only $12,000

The average U.S. household Retirement Account balance is $3,000

Who is going to be on the hook for the funding shortfall in these individual retirement plans?

Source: National Institute of Retirement Security

MISSOURI LAGERS
A Secure Retirement for All