



Illinois Municipal Retirement Fund

Suite 500 2211 York Road Oak Brook IL 60523-2337

Service Representatives 1-800-ASK-IMRF

www.imrf.org

Briefing Paper

Topic: Defined Benefit (DB) and Defined Contribution (DC) Plans

Subtopic: Advantages and Disadvantages

Defined Benefit Plan Advantages

- Provides guaranteed lifetime income to retirees (you cannot outlive your benefits)
- Employer bears investment risks, but has a long-term investment horizon
- Less costly to operate
- Provides inflation protection during working career since formula typically uses last years of service to calculate benefit
- Provides a benefit with an easily understandable relationship to working pay just before retirement
- Motivates employees to continue in service; provides a determinable, guaranteed benefit allowing smooth transition at end of service
- Allows for benefit enhancements through out-of-system service; service before plan inception, military service, early retirement incentives
- Typically allow for cost-of-living protection through post-retirement benefit increases

Defined Benefit Plan Disadvantages

- Employer costs fluctuate year to year due to investment returns and variations from actuarial projections
- Usually more complicated to administer
- Longer vesting periods, provides less income for non-career employees
- Not designed for portability between employers
- Considered more difficult to understand

Defined Contribution Plan Advantages

- Contribution amount is easily determined by the employer (employer assumes no investment risk)
- Pension costs for service rendered are fully funded
- Accounts are portable with balances easily transferable to the employee's next retirement plan or an IRA
- Employees can easily identify a specific dollar amount that is earmarked for them and placed in individual accounts
- Typically provides more income for non-career employees and affords an opportunity for higher benefits if investment experience is superior

Defined Contribution Plan Disadvantages

- Employee bears investment risk and must become financially savvy
- Unless the employee annuitizes their account balance, they can outlive their savings
- Benefits may not bear any relationship to working pay
- Per dollar of benefits paid, a DC plan is more expensive to operate than a DB plan
- Outside service credit is not easily translated into a larger account balance
- Does not motivate employees to continue in service if their account balance is deemed adequate or if they can transfer their retirement account to a new employer's program
- No post-retirement increases in benefits
- Difficult to translate a lump sum account balance into a steady monthly or annual income stream

** Abstracted from a November 17, 2003 Gabriel, Roeder, Smith & Co. Research Memorandum by Alan Sonnastine, Brian Murphy and Paul Zorn.*

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