

A Better Bang for the Buck The Economic Efficiencies of Defined Benefit Pension Plans

Overview

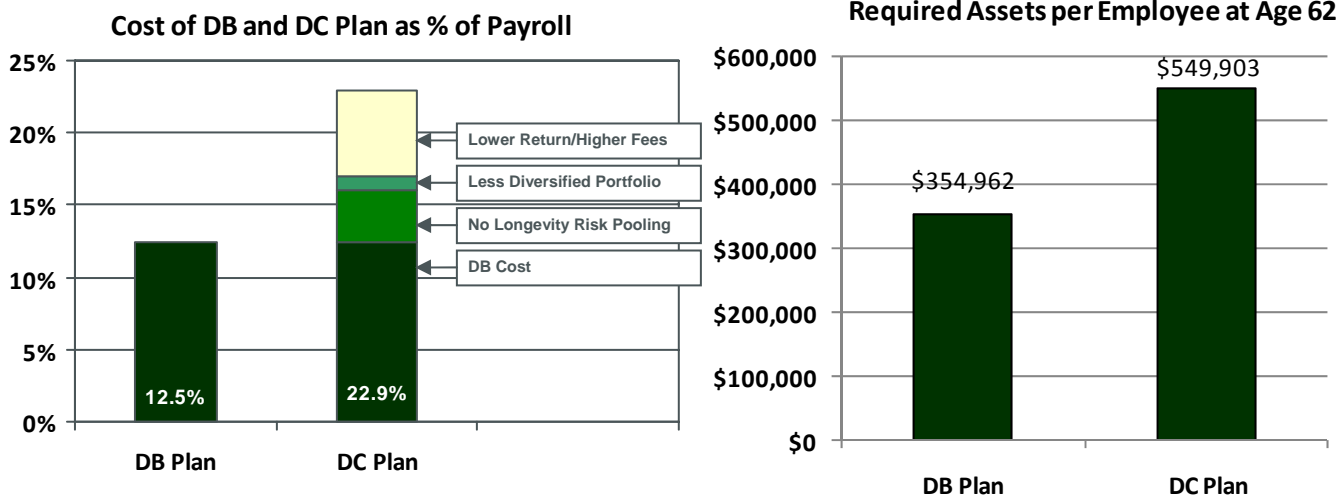
The National Institute on Retirement Security has released a new report, “A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans.” The report presents an original analysis on the efficiencies of defined benefit pension (DB) plans, and the costs of DB plans as compared to 401(k)-type individual defined contribution (DC) plans.

The report’s analysis and findings serve as a myth buster with respect to the costs of defined benefit pension plans. Specifically, the embedded **economic efficiencies of DB plans make them nearly half the cost of DC plans, or a 46 percent cost savings.**

Policy and decision makers can utilize these findings to make informed decisions about retirement security issues and to evaluate claims that DC plans save money. The report concludes that DB plans should remain a centerpiece of retirement income policy and practice, especially in light of current fiscal and economic constraints facing corporate and government retirement plan sponsors.

Methodology

The model makes an “apples to apples” calculation of the actual dollar contributions required for a DB and DC plan to achieve the same target retirement benefit. The target retirement benefit in the model is \$26,684. Together with Social Security benefits, this retirement benefit allows a retiree to replace 83% of pre-retirement income, which meets generally accepted standards of retirement income adequacy.



Key Findings

The DB plan provides the best bang for the retirement buck. Under the model, the DB plan provides the same retirement income at nearly **half the cost - 46 % less** than individual 401(k)-type DC accounts.

Under the DB plan, contributions of 12.5% of payroll each year are required to fund the target retirement benefit. The DB plan will need to have \$355,000 set aside for each participant by the time the worker turns 62. In contrast, the DC plan requires contributions of 22.9% of payroll each year. The less-efficient DC plan will need to have \$550,000 set aside for each participant in the plan by the time the worker turns 62. In other words, the DB plan can provide the same benefit at a cost that is 46% lower than the DC plan. **The DB plan can do more with less providing the same benefit for nearly \$200,000 less per participant.**

Economic Efficiencies Are Embedded in DB Plans

DB plans have certain embedded characteristics that drive their economic efficiencies:

1. **DB Plans Avoid “Over-Saving.”** We won’t all live to be ninety-five or one hundred. But in an individual plan, many of us will want to save enough to last until very old age to avoid the risk of running out of money. However, a DB plan only has to save for the AVERAGE life expectancy, which is much lower and which actuaries can calculate with a high degree of accuracy. By saving for a realistic average life expectancy, the DB plan realizes a **15% cost savings** over the DC plan. In technical terms, this is called “longevity risk pooling.”
2. **DB Plans Stay Forever Young.** Individuals age. Therefore, those in individual retirement plans must adjust their asset allocation to ensure sufficient cash is on hand to last throughout retirement. Most financial advisors counsel downshifting from higher risk/higher return investments to lower risk/lower return investments as they get older. This protects individuals from the risk of a stock market crash, but progressively reduces the investment returns that can be earned in retirement piggybanks. However, a DB plan exists across generations and therefore can always maintain the most optimal asset allocation. There isn’t a need to be overly weighted in lower return/risk bonds or cash. This results in a **5% cost savings** over the DC plan.
3. **DB Plans Achieve Higher Investment Returns.** The higher returns of DB plans as compared to individual accounts can be attributed a combination of professional asset management and lower fees. A retirement plan that earns greater investment returns will require less money in contributions. Even seemingly small differences in annual returns compound over time. In our model, a 1% difference in annual investment returns results in a **26% cost savings** over a career, as compared to the DC plan.

Summary

“A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans,” makes it clear that the embedded economic efficiencies of DB plans enable them to deliver the **same benefit at nearly half the cost of DC plans, or a 46 percent cost savings**. While the efficiencies of DB plans are well documented, this report is important in terms of quantifying the magnitude of those efficiencies.

The report’s findings also serve as a myth buster to conventional wisdom with respect to the fiscal efficiencies and costs of DB pension plans. In fact, **DB plans are the most fiscally efficient means of providing a modest but stable retirement income that cannot be outlived**. DC plans are important to the retirement security equation, but they were not designed to stand on their own.

Policy and decision makers can utilize this data to make informed decisions about retirement security issues and to evaluate claims that DC plans save money. The report concludes that DB plans should remain a centerpiece of retirement income policy and practice, especially in light of current fiscal and economic constraints facing corporate and government retirement plan sponsors.