Defined Benefit Plans vs. Cash Balance Plans: Choosing the Right Retirement Benefit

When it comes to retirement planning, employers have the responsibility of selecting the best retirement benefit plan for their employees. Two popular options are Defined Benefit (DB) plans and Cash Balance (CB) plans, each with its unique features and advantages. Understanding the differences between these plans is crucial for employers to make an informed choice.

Defined Benefit Plans (DB):

Defined Benefit plans are the traditional pension plans that provide employees with a fixed, predetermined benefit upon retirement. This benefit is typically calculated based on factors like the employee's salary and years of service with the company. DB plans offer several key characteristics:

1. Income Promise: DB plans promise a specific retirement income to employees, usually based on a formula that considers their salary history and years of service. This provides employees with a sense of financial security during retirement, knowing they will receive a predetermined benefit.

2. Employer Responsibility: Employers bear the primary responsibility for funding and managing DB plans. They must contribute sufficient funds to cover the future retirement obligations of their employees. This often requires actuarial calculations and potentially significant financial commitments.

3. Guaranteed Retirement Income: One of the primary advantages of DB plans is that employees can rely on a guaranteed stream of income during retirement. However, these plans typically do not adjust for inflation, meaning the purchasing power of the benefit may decrease over time.

4. Complexity: The funding and administration of DB plans can be complex and costly for employers. They must navigate actuarial calculations, investment management, and compliance with regulations. Market fluctuations and changing workforce demographics can also impact the cost of funding these plans.

Cash Balance Plans (CB):

Cash Balance plans offer a different approach to retirement benefits. They combine elements of both Defined Benefit and Defined Contribution plans, providing employees with individual account balances. Key features of CB plans include:

1. Hybrid Structure: CB plans are often described as hybrid plans because they offer elements of both DB and DC plans. Employers make annual contributions to each employee's account, typically based on a percentage of their salary.

2. Transparency: Employees have clear visibility into their individual account balances in CB plans. These balances grow annually with employer contributions and interest credits, providing employees with a sense of ownership and control over their retirement savings.

3. Portability: Unlike traditional DB plans, CB plan benefits are typically portable. If an employee leaves the company, they can take their accrued CB plan balance with them. This can be rolled over into an Individual Retirement Account (IRA) or another retirement plan, providing greater flexibility.

In conclusion, the choice between Defined Benefit and Cash Balance plans depends on various factors, including an employer's financial goals, the demographics of their workforce, and their desire to offer retirement benefits that balance security and flexibility. DB plans offer a guaranteed income but come with complexity and cost, while CB plans provide transparency, portability, and some investment risk sharing. Employers should carefully assess their unique circumstances and the needs of their employees when selecting the most suitable retirement benefit plan. Consulting with financial and legal experts is often advisable to make an informed decision.