Q. What are defined benefit retirement plans?

A. Defined benefit retirement plans are lifetime annuities promised by employers and, in most cases, partially guaranteed by the federal government.

Defined benefit plans promise to pay a pre-determined benefit at retirement, usually determined by an employee's salary and years of service with the firm. Employers typically make all contributions, although some plans require employee contributions or permit voluntary ones.

RISKS

Under a defined benefit plan, an employer promises an employee an annuity at retirement. The employer, not the employee, bears the most risk in a defined benefit plan. If retired employees live longer than anticipated, or if the investments financing the employees' pensions fail to meet expectations, the employer must increase contributions to make good on the promised benefits. Defined benefit plans are thus more likely to be offered by large employers, who are better suited to bear the risk and to spread fixed administrative costs across larger numbers of participants.

However, not all the risk falls on employers. Employees bear some risk of nonpayment if the defined-benefit plan is unable to pay benefits. A portion of the non-payment risk is covered by the Pension Benefit Guaranty Corporation, a federal entity that ensures retired workers receive at least some of their benefits if their employers are unable to pay the promised sums in full.

TRENDS

Defined benefit plans have been falling in popularity (at least among employers) over the past few decades. For families with active participation in retirement plans, the share with a defined benefit plan fell from 40 percent in 1992 to 17 percent in 2016. Defined benefit plans, however, are still the most common type of plan for government employees.

Further Reading

Congressional Budget Office. 2011. "Use of Tax Incentives for Retirement Saving in 2006." Washington, DC: Congressional Budget Office.

Employee Benefit Research Institute. 2018. "Individual Account Retirement Plans: An Analysis of the 2016 Survey of Consumer Finances." Washington, DC: Employee Benefit Research Institute.