GLOSSARY

Cash Balance Plan is a *defined benefit plan* that has an account like that of a *defined contribution plan*. Although not all cash balance plans are identical in design, they generally involve an employer crediting a percentage of pay to an employee's account. Employees may often contribute to the account. Annual investment credits are added to the account. Unlike a *defined contribution plan*, however, the investment credits are not related to the investment earnings of the plan. Instead, the employer guarantees that employee account balances will increase at a specified rate.

Death Benefits are paid to the survivor of a *plan participant* who dies while still on the job. They differ from *survivor benefits*, which are paid to a survivor upon the death of a *plan participant* who is in retirement status.

Deferred Compensation Plan is a type of retirement savings plan in which an employee voluntarily contributes a portion of his/her salary up to an annual limit on a tax-favored basis. The money and earnings from it are not taxed to the employee as current income but taxed as income when received. Employers sometimes match employees' contributions. State and local government employees are eligible for "Section 457 deferred compensation plans." These plans are offered by either the state or a local government. Some education employees now have such plans available to them. A similar type of plan, a "Section 403(b) tax-sheltered annuity," also known as a "tax-deferred annuity," is usually available to education employees. Section 403(b) plans provide the similar tax benefits as Section 457 plans do.

Deferred Retirement Option Plan (DROP) allows employees with a *defined benefit plan* to accumulate a lump sum. Although DROPs take various forms, they usually involve an employee who is eligible to retire. The employee may elect to participate in the DROP. Retirement benefits that are earned while in the DROP go into an account. The employee continues to work some specified period of time. The benefits in the account earn interest. When the employee finally stops working, he/she draws his/her monthly retirement benefit and usually takes the DROP amount as a lump sum.

Defined Benefit Plan is a retirement plan that offers a benefit determined by a specific formula. The benefit is usually tied to an employee's earnings and length of service, multiplied by some percentage. It affords a guaranteed retirement benefit that cannot be

reduced. It provides not only retirement benefits but also, in most cases, disability, death, and *survivor benefits*. It can also incorporate early retirement incentives and cost of living adjustments.

Defined Contribution Plan is a retirement plan in the form of an account in which contributions are invested and earn income. Employers, employees, and sometimes both make the contributions. When a participant in a *defined contribution plan* retires, the amount in the account represents his/her retirement income. The participant can take out the money at one time or withdraw it through monthly benefits or some other time interval.

Disability Retirement is a feature offered as part of a *defined benefit plan* of a state and local government. If a *plan participant* is no longer able to perform his/her job due to injury or illness, he/she may qualify for a *disability retirement*. In that event, he/she is eligible for a retirement benefit even though he/she has not met the age and service requirements.

Early Retirement allows an employee to retire earlier than normal retirement in exchange for a reduced benefit. The reduced benefit may be viewed as a form of penalty. It is different from an *early retirement incentive* program.

Early Retirement Incentive Program (ERIP) provides enhanced retirement benefits during a specific period to encourage employees to retire. Unlike *early retirement*, there is no penalty. Instead, an ERIP offers an enhancement, usually in the form of additional years of service credit. For example, an eligible employee will receive a month of additional retirement credit for each year of service credit for a maximum of three additional years.

Hybrid Plan is a plan that combines the concepts of both *defined contribution* and *defined benefit plan*s. Some *hybrid plans* contain an employer-financed *defined benefit plan* and an employee-funded *defined contribution plan*, for example, Washington Teachers Retirement System Plan 3 and School Employees Retirement System Plan 3. Other *hybrid plans* compute an individual's benefit under both a defined benefit formula and a defined contribution method and pay the individual whichever yields the higher amount. In Wisconsin, for example, the *money purchase plan* uses the employee and matching employer deposits in the individual's account multiplied by an actuarial money purchase factor based on his/her age when the annuity begins. In Colorado, the *money purchase plan* method uses the following factors: 1) the individual's life expectancy; 2) the value of the individual's account (his/her contributions and interest); and 3) a matching amount equal to 100 percent of the amount in the individual's account. Both systems calculate an individual's benefit under the two methods and pay the individual the higher amount. For short service employees, the *money purchase plan* sometimes results in a higher benefit than under the *defined benefit plan*.

Lump Sum Cash-Out occurs when an individual leaves an employer from which the individual had a retirement plan, takes the funds from the plan, and uses them for non-retirement purposes. The individual pays any income tax due. He/she may also have to pay an early withdrawal penalty of 10 percent if he/she is younger than 59 _ or under other circumstances. An individual has options other than cashing out. He/she can leave the funds with the former employer. If the individual's new employer has a plan, he/she may be able to rollover the funds into the new plan. Alternatively, if the individual's new employer has no plan (or if the individual does not go to work for another employer), he/she can roll the funds into an Individual Retirement Account (IRA). If the individual takes one of the latter approaches, he/she will likely avoid the penalty and will not be liable for taxes until he/she takes the funds at retirement.

Money Purchase Plan is a type of *defined contribution plan*. Such plans take many forms, but they usually include an employer contribution stated as a percentage of employee salary. As noted under *hybrid plans*, some retirement systems calculate an individual's retirement benefit under the defined benefit formula and also under a *money purchase plan*. For short service employees, the *money purchase plan* sometimes results in a higher benefit than under a *defined benefit plan*.

Normal Retirement is the point at which a *plan participant* is eligible for an immediate, unreduced retirement benefit. A *plan participant* must usually meet some combination of age and years of service to be eligible for normal retirement. In some states, normal retirement is based on years of service only.

Plan Participant is a member of a retirement plan and can be an active member (working), an inactive member (terminated, but not yet eligible for a retirement benefit), or a retired member.

Portability is the right of an individual to move funds from one pension plan to another. Under most governmental *defined benefit plans*, state law allows employees to recover service credit for earlier years of work for which they will not earn such credit. These laws allow them to "purchase prior service credit," sometimes known as "buying back prior service." Typically, employees may purchase service credit for work with a previous employer that was not long enough to result in a pension benefit. Previous employers may include other state and local governments, the federal government, or for-profit and non-profit entities. In the context of *defined contribution plans*, an employee upon terminating employment may rollover funds in his/her account to 1) an Individual Retirement Account (IRA) that he/she manages; or 2) a retirement plan of his/her new employer (assuming the employer offers a plan).

Survivor is an individual designated by a *plan participant* to receive death benefits, if the *plan participant* dies while still on the job, or *survivor benefits*, if the *plan participant* dies while in retirement status. The survivor is sometimes called the beneficiary.

Survivor Benefits are paid to an individual designated by the *plan participant*. The survivor receives benefits upon the death of the *plan participant* who is in retirement status. They differ from death benefits, which are paid to a survivor upon the death of a *plan participant* who is still on the job.

Transfer of retirement funds occurs when one retirement plan is willing to accept assets from another retirement plan.

Vesting occurs when an employee acquires an irrevocable right to his/her accrued benefits under a pension plan, even if he/she leaves employment prior to eligibility for an immediate retirement benefit. A vested benefit may be paid as a lump sum or, frequently, is paid as a deferred annuity upon retirement.

FREQUENTLY ASKED QUESTIONS

Q. How can DB plan sponsors respond to the needs of employees seeking greater portability and flexibility?

First, they can maximize portability by allowing purchases of prior service credit, sometimes known as “buying back prior service.” Such purchases allow plan participants to buy back service credit for work with a previous employer that was not long enough to result in a pension benefit. Second, they can enhance the benefit of short service employees, which affords greater flexibility. Some defined benefit plans index the future retirement benefit of an individual who has terminated service before retirement eligibility. This indexing is, in effect, a COLA that increases the value of an individual’s benefit between the time of termination of service and retirement eligibility. In other plans, a plan participant who terminates before retirement eligibility receives a matching contribution if he/she withdraws his/her benefit or a larger match if he/she waits until retirement eligibility.

Q. Will converting to a DC plan improve the unfunded liability of a DB plan?

Converting to a DC plan does just the opposite. It actually worsens the unfunded liability of an existing DB plan. This is because fewer individuals will be participating in the DB plan. Thus, contributions into the DB plan from employers and employees will decrease. The smaller amount of contributions may actually require an increase in contributions at a later time to ensure all promised benefits are paid. In addition, some pension funding methods use the ongoing flow of new, younger members to help finance the cost of the plan’s promised benefits. For plans that rely on those methods, redirecting future employees from a DB to a DC plan can raise the cost of the DB plan.

Q. Do DB plans have value for younger, short-service employees?

Yes. An employee need not spend his/her entire career with the same employer to benefit from a DB plan. A DB plan affords a guaranteed retirement payment for vested participants. (In most education retirement systems, vesting takes place in five or fewer years.) A DB plan can provide a retirement benefit that is greater than the benefit from a well-invested DC plan, depending on the age of the participant when beginning and terminating employment. Moreover, the DB plan usually offers features such as disability benefits and death benefits (payable to the survivor of an individual who dies while still on the job). These features are not usually available in a DC plan.