Background Information on
Basic Operation of Defined Benefit Plans and Defined Contribution Plans

General Distinction between Plan Types

There are two major factors or elements in designing retirement plans. These are the level of the benefits and the level of contributions. When one factor is fixed or made pre-determinable, the other factor is automatically made variable. If the level of benefits or computation of benefits is fixed or established by formula in law, the plan is a defined benefit plan, and the contribution rate is variable, adjusted as necessary to ensure that the liabilities of the plan are covered. If the level of contribution is fixed, the plan is a defined contribution plan. With a defined contribution plan, the benefit level is unspecified. The benefit level will ultimately be determined through the investment markets, which will determine the growth of the assets prior to distribution.

Defined Benefit Plans and Defined Contribution Plans in Minnesota

In Minnesota, public pension plans by both number and membership are predominantly defined benefit pension plans. The following is a list of defined benefit Minnesota public pension plans and defined contribution Minnesota public pension plans.

Defined Benefit Plans	Defined Contribution Plans
1. General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General)	1. Unclassified Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified)
2. Correctional Employees Retirement Plan of the Minnesota State Retirement System (MSRS-Correctional)	2. PERA Defined Contribution Retirement Plan (PEDC)
3. MSRS Military Affairs Retirement Plan	3. Individual Retirement Account Plan (IRAP)
4. MSRS Transportation Department Pilots Retirement	4. College and University Supplemental Retirement Plan
5. State Patrol Retirement Plan	5. Volunteer Firefighters Relief Associations (about 75)
6. MSRS Elective State Officers Retirement Plan	6. Ambulance Personnel Longevity Plan
7. MSRS Legislators Retirement Plan	7. Hennepin County Supplemental Retirement Plan
8. MSRS Judges Retirement Plan	8. University of Minnesota Faculty Plan
9. General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General)	9. Public Employee Supplemental Thrift Plan through State Deferred Compensation Plan or selected tax-sheltered annuity programs
10. Public Employees Police and Fire Retirement Plan (PERA-P&F)	10. Housing and Redevelopment Agency Retirement Plans
11. Local Government Correctional Service Retirement Plan (PERA-Correctional)	11. Pre-1971 School District Supplemental Retirement Plans (total of 8)
12. Public Employees Retirement Association Statewide Lump-Sum Volunteer Firefighter Retirement Plan (PERA-SVFP)	
13. Teachers Retirement Association (TRA)	
14. Duluth Teachers Retirement Fund Association (DTRFA)	
15. St. Paul Teachers Retirement Fund Association (SPTRFA)	
16. Volunteer Firefighter Relief Associations (about 625)	
17. University of Minnesota Faculty Supplemental Plan	

Basic Operation of Defined Benefit Plans

These plans are called defined benefit plans because the benefit is defined in law. Law for these plans states that the benefit payable from these plans is to be computed by multiplying three factors: the high-five average salary, the accrual rate, and years of covered service. The high-five average salary is the average salary over the five-year period which produces the highest average. For individuals who work full time up to retirement, the high-five years are generally the five years just prior to retirement or termination of service. This follows because salaries tend to increase over time due to inflation and due to merit raises and promotions. In some cases where individuals work overtime in mid-career but then cut back near retirement, the high-five may not be the last five years. The accrual rate or rates are stated in statute. It is the percentage of the high-five average salary which the person receives per year of service.

To illustrate using an example, in the PERA-P&F Plan the accrual rate is 3.0%. This means that individuals who retire from that plan receive 3.0% of the high-five average salary for each year of service they provide. If the high-five average salary is $50,000 and the individual provided 30 years of covered service, then the annual pension benefit for the individual (providing that he or she is at least at the normal retirement age for this plan, age 55) is $45,000. This is computed by multiplying $50,000 x 30 years x 3.0%, which equals $45,000.

PERA-P&F is a public safety plan and is not coordinated with Social Security. The employee and employer do not pay into the Social Security system and the individual does not accrue a Social Security benefit due to the public safety employment. The accrual rate in PERA-P&F, and also in the similar MSRS State Patrol Plan, is high, 3.0%. The rate is high in recognition that the person will not be receiving any Social Security benefit in retirement due to the public safety employment. General employee plans, such as TRA and the first class city teacher plans, or MSRS-General and PERA-General, are coordinated with Social Security, and the Minnesota public plan provides a lesser benefit in recognition that part of the person's retirement income will be coming from Social Security. The accrual rate assuming the person retires at normal retirement age in these general employee plans (age 65 if the person started covered employment before July 1, 1989, or age 66 if the employment commenced after June 30, 1989) is 1.7%, although TRA is somewhat higher at 1.9%, for recent employment.

Since defined benefit plans pay benefits that are determined by high-five average salary, the accrual rate or rates, and years of service, the value of the specific benefit paid to any individual is not a direct function of the employee and employer contributions made specifically for the individual. Rather, the plan actuary needs to predict the required contributions for the entire covered group, given the liabilities expected due to the demographics of the group, the likelihood that individuals entering the plan will eventually draw plan benefits, the mortality of plan participants, and other factors. Thus, the benefits are defined, but the contributions are not. Those contributions are adjusted in law over time as necessary to meet the liabilities created by the plan.

For individuals who tend not to change jobs, at least not between different employers, and who provide long service, defined benefit plans is the coverage preferred. The benefit is predictable, and the long service leads to a sizable benefit. Defined benefit plans tend to penalize short-service employees. When individuals terminate after several years of employment, often the best financial option available to the individual is to take refund from the pension plan. By taking a refund, the individual gives up any right to a pension from the plan. The refund consists of the employee contribution plus 6% interest. This does not make the terminating employee whole. The plan keeps the employer contributions made on behalf of the individual and all investment earnings above the interest paid on the refund. The retained moneys are used to offset some of the liabilities of the remaining plan membership. These retained amounts are referred to as turnover gain. Without turnover gain, the contribution requirements to our defined benefit plans would be much higher.

Basic Operation of Defined Contribution Plans

There are several state-level defined contribution plans. These are the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), PERA's Public Employees Defined Contribution (PEDC) Plan, and a few Individual Retirement Account Plans (IRAPs). MSRS-Unclassified provides coverage to post-1997 legislators, pre-1997 legislators who elect this coverage, judges who have exceeded the maximum years of service permitted under the Judges Plan, and various unclassified employees. The PEDC provides coverage largely to local elected officials. The IRAPs provide coverage to higher education faculty within the Minnesota State Colleges and Universities System (MnSCU) who choose this coverage, Minnesota Historical Society employees, and supervisory and professional employees of the State Arts Board and Minnesota Humanities Center.

In a defined contribution plan, the contribution is determined, but the benefit is not. The plan specifies in law the employee and employer contribution rates that will be paid to an account for the individual. This account is invested in stocks, bonds, and other investments offered through mutual fund-like options that the plan makes available to its membership. In Minnesota plans, the individual selects these investment options.

The value of the account when the individual terminates or retires is unknown; that will depend upon how long the individual works and upon the returns provided by the investment markets on the contributed amounts. Thus, the benefit is undetermined. At retirement, the individual can take the value of the account and purchase an annuity, or, under MSRS-Unclassified, create an annuity payout by rolling the account's value into the MSRS-General fund, which pays the benefit that can be supported by that account value and which provides post-retirement increases during retirement.

Employment-mobile employees often prefer defined contribution plan coverage. When they change jobs, they retain the full value of their account and it can move with them. The pension portability of defined contribution plans is an attractive feature to these employees.