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The Case for Defined Benefit Plans

"The Best Way To Secure Your Financial Independence"

The Illinois Municipal Retirement Fund (IMRF) Board of Trustees and staff are charged, by statute, *"…to efficiently and impartially develop, implement and administer programs that provide income protection to members and their beneficiaries on behalf of participating employers in a prudent manner."*[1] Since its inception in 1939, IMRF has provided a guaranteed retirement benefit to public employees which will last a lifetime. In the pension community, such guaranteed benefits are known as a defined benefit plan, since the nature of the benefit is known in advance and the recipient cannot outlive his or her annuity.

IMRF believes a defined benefit plan is the best approach for providing financial security for persons in retirement and is the most cost efficient method for employers to attract and retain qualified people who perform critical work in the public sector. For public sector employees, a defined benefit plan provides a cost-effective, proven and stable method to save for retirement. Moreover, taxpayers can expect public employees to focus on providing public services instead of trying to become investment experts.

At a time when Social Security benefits are under duress due to increased longevity and the retirement of the Baby Boomer generation, a defined benefit plan should be seen as one of the few means of effectively providing income protection and maintaining an adequate standard of living when employees are unable or no longer wish to work.

Defined benefit plans are a tried and true method of securing one's retirement. What was once called old-fashioned is—in fact—the cutting edge of providing financial security for those in retirement.

This paper is intended to educate, provoke thought, and defend defined benefit plans so that they flourish in both the public and private sectors.

How A Defined Benefit (DB) Plan Works-The IMRF Example

"A Sacred Promise by Each Generation to the Elderly"

In a typical DB plan, an employee will receive a retirement benefit based on a formula consisting of three components: length of service; a multiplier; and, final rate of earnings. Once the employee retires, the benefit is payable for life in the form of monthly payments (an annuity). Variations abound for the three components as well as additional provisions such as eligibility for a benefit (vesting), cost-of-living adjustments, surviving spouse benefits, disability benefits and pre-retirement death benefits. Retirement benefits are paid from contributions (by employer, employee or both) and investment earnings.

In IMRF's regular plan, an employee earns one month of service for each month worked and paid. For each year of service, the employee earns 1.67% (the multiplier) of his or her final rate of earnings for the first 15 years worked; then 2% per year thereafter. The final rate of earnings is the highest four-year average, thus closely approximating pre-retirement earnings. A person with 20 years of service and a final rate of earnings of $40,000 receives a pension of $14,000 per year or $1,166 per month (15 years times 1.67% plus 5 years times 2% equals 35% of $40,000). In retirement, the employee also receives an annual increase of 3% of the original retirement benefit (non-compounded). If the employee retires with an eligible spouse, the spouse would receive one-half the employee's pension if the spouse survives the retiree.

Prefunding the pension is key to building reserves to pay the benefit. Prefunding should be contrasted with a pay-as-you-go system, such as Social Security. In a private sector DB plan, typically only the employer funds the cost. In the public sector, the employee bears a portion of the cost. In the IMRF regular program, the employee pays 4.5% of pay; the employer pays 8.38% for retirement, death and disability benefits. Investment returns are another source of funding and pay all administrative expenses. In most years, these returns provide the largest source of revenue for IMRF. At retirement, investment earnings may provide as much as 80% of the cost for the retirement benefit.

Because public employees contribute a significant portion to funding their own pensions, IMRF views their pensions as a form of deferred compensation. In Illinois, public employees' retirement benefits are protected by the Illinois Constitution[2] and recognized as a contractual right, which cannot be diminished.

This means the full faith and credit of the citizenry of Illinois guarantees payment of the promised retirement benefit. This is somewhat analogous to the guarantees offered in the private sector through the Pension Benefit Guaranty Corporation (PBGC). Both methods reflect a sacred promise by each generation to the elderly: When you are too old or infirm to work, you will be able to live in dignity and without being a burden on your family or the public welfare system.

In a defined benefit plan, the investment gains and risks are borne by the employer and not the employee. This reduces financial stress on the employee while working and when he or she is in retirement. It may also place short-term financial pressure on the employer due to fluctuations in the investment markets. When there are investment losses, the employer may be required to contribute more to fund the retirement plan. Similarly, when there are gains greater than expected, the employer can contribute less.

At IMRF, we invest for the very long term. We assume we will make 7.5% on investments. We are able to ride out volatile markets in part because nearly $23 billion in assets are pooled and invested across multiple diverse asset classes. Assets are professionally managed with oversight furnished by the IMRF Board of Trustees, professional investment staff and independent consultants. All of these parties are known as fiduciaries which are required by law to act with the exclusive purpose of protecting the beneficiaries[3].

Administrative and investment expenses are paid by the employer and not deducted from any benefit payments made to the retiree. Economies of scale, especially at a public pension plan the size of IMRF, and non-profit administration, drive down costs. In 2006, IMRF paid approximately four-tenths of 1% to administer the program and invest plan assets. That translates into a cost of forty cents for every $100 in assets. Along with making secure investments, holding down costs is a key to long-term wealth accumulation. It also means employers contribute less to fund benefits.

As a general rule, DB plans are not portable in the private sector. If you leave an employer, you cannot transfer the plan to your next employer. In the public sector, reciprocal arrangements (as in Illinois) or the purchase of service (i.e., months or years of work with another employer) allow a degree of portability. Vesting in employer contributions so that you can receive a retirement benefit after termination of employment is typically five years (eight years in IMRF's case).

Retirement benefit payments can begin as early as age 55 in the regular plan with a reduction for early retirement. The "normal retirement age" is 60 with no reduction. It takes 40 years of service to receive a maximum benefit which is 75% of an employee's final rate of earnings.

How a Defined Contribution (DC) Plan Works

"Asking Employees to Develop the Skills and Discipline of an Expert Investor"

In a typical DC plan, employees voluntarily enroll in an employer-sponsored individual investment savings account. The ultimate retirement benefit is the accumulated value of the participant's account, and has no relationship to pre-retirement earnings. The value of the account at retirement is dependent on four factors: the level of employee contributions; the level of employer matching contributions; investment returns or losses; and, the fees paid. The end result is not an annuity payable for life, but rather a lump sum from which monies are deducted as needed. Alternatively, the lump sum can be the source of funds to purchase an annuity through a third party (typically an insurance company).

Under a DC plan, the amount the employee receives as a monthly retirement benefit relates to when the employee enrolled; the amount he or she contributed; the size of the employer match; how well the assets were invested; the expenses paid; the rate at which the retiree draws down on the lump sum after retirement; or, how much the retiree pays for the annuity.

Familiar forms of DC plans are individual retirement accounts (IRAs); 401(k) plans, 403b plans and 457 plans. Many public employees in a DB plan supplement their retirement savings by enrolling in 403b and 457 plans.
In a DC plan, the employee bears all investment risk. He or she must become knowledgeable about investing and must develop the discipline and skills necessary to achieve success. This also means a commitment in time; procrastination or hesitancy to act will undercut what would otherwise have been a successful program. He or she must decide which investment categories to invest in, which managers to select and how much to allocate to each. Increasingly, people are recognizing that investment fees have a major impact on the size of their nest egg.

The employee also bears all longevity risk. In other words, the employee can outlive his or her assets. Since life expectancy is unknown, the assets the employee accumulates during his or her working career must be drawn down at a pace which ensures monies will always be available should the employee live longer than expected. A healthy 65 year old can expect to live 18 more years and an 80 year old can expect to live eight more years, whereas, an 85 year old can expect to live a six years longer. Moreover, these numbers are just averages. Half of all retirees *will* outlive the average life expectancy. So, you see, outliving the monies accumulated in a DC plan is a real risk which can destroy a retiree's peace of mind and financial security[4].

Typically, in a DC plan the employee pays administrative and investment expenses. Administrative expenses are not subject to negotiation and usually offered on a take-it or leave-it basis. With respect to investment expenses, most employees effectively pay the full retail expense. Fees can be three, four or five times higher than those paid by employers sponsoring DB plans. A 1% increase in fees over a lifetime of savings can reduce the employee's retirement nest egg by a considerable amount.[5]

Positive aspects of DC plans relate to their portability and early vesting periods. If an employee changes jobs or employers, the account can be maintained. If the new employer offers a DC plan, typically assets can be transferred to the new plan creating a larger pool of investment monies. Even if the new employer offers no such plan, the employee can roll over the account balance to a new or existing IRA.

Vesting concerns the employee's ability to leave employment and retain the employer's contribution to the plan (the employee will always be entitled to keeping his or her own contributions). With DC plans, an employee typically becomes vested in some portion of the employer's contributions after one or two years in the program. It may take several years (according to a schedule) to become vested in all the employer's contributions. Vesting can take as long as five years.

Withdrawals can begin at any age, but typically there is a 10% federal income tax penalty for persons withdrawing monies before age 59-½.

Interestingly, 401(k) plans (which have become the major and only retirement programs with many private sector employers) were never intended to be a stand-alone plan. When introduced in 1978, 401(k) plans usually functioned as a supplement to a traditional DB plan, often incorporating elements of pre-existing thrift or profit sharing arrangements.[6]

Benefits of DB Plans to Units of Government, Illinois Taxpayers and Society In General

"Ensuring Delivery of Vital Public Services, Stretching Taxpayer Dollars, Providing a Critical Source of Capital"

Assets in public DB plans total nearly $3 trillion. In Illinois, the amount is well over $120 billion. These plans are significant sources of capital for the state and the national economy. In effect, they are fuel for the vast economic engine upon which we all are dependent for our well-being.

a) Units of Government

The towns, school districts, counties and other units of government throughout the state which participate in IMRF, employ over 175,000 workers. They are employed in public safety, education, finance, public health and numerous other occupations that provide critical services necessary for contemporary life.

A DB plan acts as a potent benefit to attract and retain a quality workforce at a reasonable cost. With a benefit based on years of service and a career end final salary, the incentive to remain in the public sector jumps when a person is near vesting (receiving a guaranteed benefit). Retaining an experienced workforce is more important than ever as the demographics of America change. Our workforce is aging rapidly. Significant workforce shortages are forecast. It is anticipated the number of workers entering the labor market will not replace those leaving. DB plans can provide flexible incentives that encourage employees to work longer or, if need be, to slowly transition them into retirement due to the demands of the job or the employee's physical condition. Conversely, an employee's DC account balance may be inadequate to provide retirement benefits when he or she intends or needs to retire. In other words, DB plans can easily be designed to retain employees performing at peak productivity or to provide a secure retirement for people wishing to leave. In any case, employers do not wish to end up with active employees not performing at peak productivity.

DB plans are best at attracting qualified employees and retaining them throughout their careers. DC plans foster higher turnover rates, resulting in increased training costs, lower levels of productivity and, potentially the need for a larger workforce.[7]

b) Illinois Taxpayers

As a taxpayer, I want the services of a well run government at a reasonable cost. I recognize that salary is only part of the total compensation package and that a DB retirement plan is a form of deferred compensation. DB plans are a cost-effective, proven, stable method to fund retirement benefits. I do not want to foot the bill for workers who outlive their nest egg or who have inadequate or unstable retirement income.

DB plans are more efficient, they stretch taxpayer and employee dollars further in achieving any given level of retirement income. This is due in part, to two aspects of DB plans: they are prefunded (creating a large pool of assets which are invested) and the employer benefits from all investment gains which (over the long-term) can be considerable. Nationwide, from 1986 through 2005, state and local DB plan investments earned $2.26 trillion, reducing the need for additional employer/taxpayer contributions.[8] Over the last 20-year period (1988-2007), IMRF earned $19.7 billion; employers contributed $7 billion and employees contributed $3.7 billion. For that period of time, taxpayers contributed only twenty-three cents for every one dollar in income.

Approximately 85% of IMRF retirees live in state. They are your friends, neighbors and family. They buy goods and services in their hometowns. They pay real estate and other taxes. Nationwide, in 2006, there were 18.4 million state and local workers, 7.3 million retirees and beneficiaries, with $151.7 billion paid out in benefits.[9] In 2007, IMRF had 85,000 retirees and paid $913 million.

Those payments are a vital stimulus to the state and national economies. DB plans are more efficient and distribute more benefits to retirees than DC plans. Studies have been conducted to estimate the added value of DB plans to the Illinois economy. When you look at all the public retirement plans in Illinois and their payouts, it has been estimated that fully 2% of Illinois' gross state product was attributable to the value added by higher DB returns.[10]

c) Society in General

In 2007, public DB plans plan had nearly $3 trillion in assets or about $10,000 for every man, woman and child living in the U.S. These assets are a great economic engine which benefit the entire society. They promote economic growth and vitality. They stabilize and add liquidity to the U.S. and foreign financial markets.

Because DB plans invest for large groups of individuals with varying retirement dates and life expectancies, they can invest for the long-term. It's that long-term view that creates the stability and allows DB plans to invest in venture capital, and other less liquid assets, such as real estate – providing financing for new and rapidly growing companies. It may be 10 or more years before profit is realized – but that's a natural fit for DB plans. "Clearly, without this stable pool of long-term savings, U.S. interest rates would be substantially higher, the cost of capital for all companies in the United States substantially higher, overall investment substantially lower and economic growth substantially diminished."[11]

At a personal level, the benefits of a DB plan are real and substantial. Dollar for dollar, the guaranteed lifetime benefit simply can't be replaced by DC plans. On average, DC plan participants work longer, resulting in less promotional opportunities within their employer and less opportunity to replenish the workforce with younger workers. Nationwide, the expected retirement age of a DB plan participant is 63.9 and 65.1 years for a DC plan participant.[12] Finally, it is recognized that DB plans reduce poverty rates for the elderly and result in more low-income workers getting a retirement benefit, other than social security.

What's Happening in the Private Sector

"The Law of Unintended Consequences"

If DB plans are so effective, why has the private sector shifted away from them to DC plans like the 401(k)?

There are numerous factors causing the shift, many of which are not applicable to the public sector: the Employee Retirement Income Security Act of 1974 (ERISA); federal tax laws; profit motives; foreign economic competition; workforce turnover; mergers; and, bankruptcy (i.e., going out of business) to name the most significant.

The lifecycle of most corporations is inconsistent with long-term pension liabilities. Corporate focus is on quarterly performance and profit goals. Not so with units of government. There the focus is on service and annual budgets. For corporations, income can fluctuate considerably from quarter to quarter. The stream of revenue for state and local governments is more consistent and reliable. Not surprisingly, the number of workers in the private sector covered by DB plans dropped between 1992 and 2005 from 32% to 21%.[13] In the public sector, it remains fairly constant at about 90%. And when given a choice, 95% of public employees have chosen to stay with a DB plan.[14]

Funding is also different. Private sector DB plans are typically funded 100% by employer contributions. In the public sector, employees typically contribute 5% of pay (when also participating in social security); or approximately 9% when there is no social security coverage. In that case, the public DB plan provides greater benefits to offset the loss of social security coverage.

Companies in the private sector can and do go out of business. This was one of the primary reasons for passing ERISA. ERISA underwrote private pensions by creating the Pension Benefit Guaranty Corporation (PBGC). The PBGC collects premiums from private DB plans and guarantees a minimum pension to former employees of corporations going out of business. ERISA and subsequent federal laws and regulations reduced or eliminated incentives to private sector employers offering DB plans. This body of law increased the liability, expenses and regulatory requirements of maintaining a private sector DB plan. More recently, the Pension Protection Act of 2006 placed new premium costs on some employers while accelerating funding requirements. It increased the volatility of employer contribution rates and the volatility of corporate cash flows.

It is ironic, but natural, that the law of unintended consequences has played out so clearly. Unlike social security, any private pension plan is voluntary. No law requires that one be offered by an employer. In an attempt to guarantee payments to the workers, the best attributes of DB plans (a lifelong protected benefit without investment risk) have been lost to the vast majority of private sector employees. It's like accountants taking over an automobile manufacturer and building a car which is an accounting marvel but which no one wants to buy because it is cheaply made, ugly and underpowered. (Does Ford Pinto or Chevy Vega sound familiar?)

In the public sector, creation of a pension plan is also voluntary – i.e., there is no federal law requiring such a program to begin with. States and local governments create pension plans by statute or resolution. Typically, once that is performed, state constitutions or court decisions provide protection against any reduction in benefits.

Although units of government may be abolished or merged into others, the basic governmental functions never cease. Governments (unlike corporations) are not in competition with someone else. And, the protection guaranteed to its workers will continue to exist. A hundred years from now, Illinois may consolidate its 102 counties into 20 or 30, but the governmental functions performed will still be needed and the pensions paid.

The shift to DC plans in the private sector has had an identifiably negative affect on retirement security. For employees, DC plans were heralded as providing the potential for greater wealth (you could make better investment decisions) and greater freedom – portability (change jobs and take your DC plan assets with you). For employers, the advent of DC plans meant lower administrative costs; no PBGC premiums, and less red tape. The reality has not lived up to the hype for employees, although it has had the desired benefit for employers.

Numerous studies have been conducted comparing DB investment returns to DC returns. This is crucial. Your benefit will equal what you or your employer contributes plus investment returns. The lower the returns, the more that must be contributed or the lower the benefit (Benefits = Employee/Employer Contributions plus Investment Income). This is a nice, simple truism. The net result has been that DC participants make, on average, 1% or more less than DB plans.[15] Over the long run, a DC participant will have a nest egg up to 25% less.[16]

DC plans offer greater portability. As one changes jobs, the employee can transfer his or her DC account to an IRA or to the next employer's DC plan. But that does not happen early in the employee's career. Too often the money is withdrawn from the "investment account" and spent. This is known in the pension industry as "leakage," and it comes at the worst possible time in a working career. To build an adequate nest egg at retirement, employees need to fund their DC plans fully and keep that money working so that the magic of compounding interest will make the entire plan affordable or manageable. Not rolling over that $2,000 at age 25 means a magnified loss when no interest is earned on that money for the next 40 years. Assuming an 8% return, that $2,000 would have grown to $43,448 if the money had not been touched and allowed to grow income tax free.

The shift from DB to DC plans in the private sector does result in employer savings, but it has not been apples to apples. Employers are not funding DC plans at the same rate as they did DB plans. There has been an actual reduction in employer contributions.[17] Unfortunately, as employers contribute less, there is no evidence employees are contributing more. Referring back to the truism, if contributions to DC plans are less, less money is invested, and benefits will be less. Retirement wealth for households approaching retirement actually fell between 1992 and 2004.[18]

Human Nature

***"It's not what we know that gives us trouble.
It's what we know that ain't so."
-Will Rogers***

Most of us can run (especially when we were younger), but we cannot all compete in a marathon. Achieving financial security at the end of your working life is a race we all need to win. It takes a commitment (and discipline) to saving, learning and investing. It is a marathon lasting 30 to 40 years.

DB plans have investment staff which hire teams of professional managers – elite runners – to eek out the highest returns at acceptable levels of risk. If you are managing your own DC plan, you can make direct investments or hire talent by purchasing interests in mutual funds. More recent research and experience is teaching us that most of us are not able to compete with the returns generated by professional managers.

DB and DC plans have co-existed for many years. When social security is added to the mix, you create the "three-legged stool" long recognized in the pension industry as necessary to create a secure retirement. What is new is the fading of DB plans in the private sector and the promotion of DC plans as the panacea for employers and employees alike to provide affordable retirement plans. Because the employee will be called upon to fund and invest his or her DC plan, the question becomes are employees equipped to do so? What are the consequences if they are not? As much as we pay lip service to the rugged individualism of 19th century America, we are living in the 21st century and are dependent upon others to supply us with food, energy and safety. As investors, we are dependent upon others to provide us with the training and information we need to be successful.

There is a large and growing body of evidence that the average employee is not equipped by temperament or training to successfully manage a DC account, and does not have the tools (savings vehicles) necessary to achieve and sustain a secure retirement.

Humans are prone to overconfidence or to the belief that we know more than we really do. We use mental shortcuts to estimate problems and predict risks. We base long-term decisions on short-term information. Too many people chase hot mutual funds only to see them go cold. We extrapolate from small samples of data and develop grand theories, believing we have greater insight than the next person. If something is easy to recall, we think it happens frequently. We hate losing more than winning as evidenced by selling winning stocks too early and holding losing stocks too long (in the hope we will break even).[19]

Other researchers have found a significant group of employees lack the psychological attitude or interests needed to maximize retirement security. "In an ideal world, workers would be expected to join these (DC) plans and take full advantage of the tax and savings advantages they offer. In pursuit of retirement security, rational participants would be expected to calculate an adequate savings ratio and construct an optimal investment portfolio. When they change jobs, participants would be expected to avoid tax penalties and not spend their assets. At retirement, with lump sum distributions being the common form of benefit payment, workers would be expected to generate a suitable income stream from their savings for their life, managing mortality risk and avoiding the premature depletion of assets."[20]

The real world is much different. There is a litany of woes: poor returns; high costs; mishandling or not recognizing investment risk (taking on too much or too little); market-timing; following trends; not having an asset allocation (or not maintaining it); reluctance to buy annuities with that lump sum distribution; and, failure to diversify properly. I may have missed a few – but the point is clear.

A partial answer to why employees trip up in the race to a secure retirement is that not everyone is in the running. In their paper "Money Attitudes and Retirement Plan Design: One Size Does Not Fit All,"[21] the authors recognize individuals have heterogeneous savings preferences. We don't think alike or act alike when it comes to retirement planning and saving. They broke the population down into five categories: (1) Successful Planners - 21%; (2) Up and Coming Planners – 26%; (3) Secure Doers – 20%; (4) Stressed Avoiders – 19%; and, (5) Live-For-Today Avoiders – 14%.[22]

Their findings show that a large segment of the population does not have the temperament or desire to plan for the future. That bodes ill for retirement security. It highlights the inappropriateness of the DC model for a large segment of the population. The DC model needs employees who are successful planners. They need to be pro-active, engaged, and fully informed decision makers.[23] Furthermore, woe to the lower paid members of our workforce who will never have adequate discretionary income to invest in the first place.

Other research reveals additional deficiencies of the DC model as a retirement savings vehicle:

- A Hewitt Study of 200,000 people found that when leaving a job, 45% of them cashed out their retirement plan.[24]

- A study by Buck Consultants on the Nebraska Retirement System in 2000, found for the period 1983-1999, Nebraska's DB plan averaged an 11% annual return. A different segment of employees had only a DC plan. Their returns averaged 6% annually.[25]

- Research from Dalbar found that between 1984 and 2002, the average equity mutual fund investor earned only 2.6% per year, on average, compared to a 12.2% annual return for the S&P 500 index. The average fixed-income mutual fund investor earned only 4.2% annually, compared to a long-term government bond return of 11.2%.[26]

Finally, most statistics concerning DC plan returns show *average* returns – half of the investors earned less. As a result, there is a wide spectrum of winners and losers.

Life is not Lake Woebegone where all the children are above average. As in any marathon, there is only one winner. Some don't complete the race, and many runners are far down the line.

The National Dilemma

"A Growing Elder Population, Faulty Plan Design, and Human Nature"

We are no longer a nation of savers, but of consumers. The demographics are such that the fastest growing segments of our society are age 65 and older. Most of us neither can nor wish to work until we die. Our ability to live independently in retirement and maintain our pre-retirement standard of living is under increasing pressure due to inflation and galloping healthcare costs. Many people are at risk of seeing a declining standard of living and outliving their assets.

Between 1965 and 2004, inflation rose 4.62% on an annualized basis. At 2.5% inflation a year, one's purchasing power is reduced by one-half over 28 years. (The magic of compounding works both ways – in growing assets and, as we see here, in destroying assets). At age 65, a husband and wife can expect to live to 89; a single male to age 83; a single female to age 85. The probability of living to 85 for a married couple is 77%; for a single male 47% and for a single female 56%.[27] Elder households may need 65% to 85% of their pre-retirement income to maintain their standard of living or 1.5 to 3.0 times the poverty line to satisfy the most basic needs.[28] Sixty percent of middle-class retirees can expect to outlive their financial assets if they attempt to maintain their current pre-retirement standard of living.[29] For these elders, social security, family or government assistance will become their safety net.[30]

The supplanting of DB plans in the private sector with DC plans has diminished the nation's retirement security. DC plans are not part of the solution, but part of the problem when they become the only retirement savings vehicle available through the employer.

Why have DC plans failed? Two primary reasons are: their design and human nature. Typically, enrollment in a DC plan is not mandatory (or if there is automatic enrollment, an employee can opt out). Almost 25% of eligible employees do not participate.[31] For those employees participating, they are not contributing enough. Less than 10% of the participants contribute the maximum allowable amount.[32] Researchers are also finding inappropriate investment allocations (too little diversification; too conservative, infrequent rebalancing; ownership of too much employer stock).[33] This illustrates employees' inexperience in investing and a lack of investment training. Emotions and market timing are also at play. Leakage occurs as DC participants cash out savings when they leave their employers. Administrative and investment fees are substantial and will penalize even a well-executed DC plan.

At a macroeconomic level, DC plans are failing as well. Long-term investing is being replaced by pursuit of short-term gain. DC investors can't or won't pursue alternative investments or venture capital (so crucial in developing new companies). The liquidity and stability in financial markets created by institutionally invested DB plans is being lost. By moving to DC plans, the nation is also losing economic efficiency. The monies being placed into retirement savings (and not used for other purposes) need to be converted into retirement benefits. DC plans such as 401(k) plans are not used effectively for this purpose. For every dollar placed into a DB plan, eighty cents goes to the retiree. For a cash balance plan, only fifty-seven cents goes to the retiree – the rest distributed to employees leaving before retirement.[34] Looking at it another way, if the purpose of an employer who sponsors a retirement plan is to provide employees with a source of income in retirement, any monies paid before retirement are wasted dollars.[35]

Conclusion

"It's Time To Strengthen A Proven System"

Our goal is simple – ensure people in retirement, whether by choice or necessity, can take care of their own needs without burdening families, friends or society. Since 1935, the answer in America has been to build a three-legged stool: social security, an employer retirement plan (DB) and personal savings. The federal government has an interest in assuring that all Americans have a secure retirement as reflected in the Internal Revenue Code and tax policy which defers taxes on contributions to public and private retirement plans.[36]

The need is immediate. The path is clear. Other commentators have shown us the way. Rebuilding the promise of retirement security will mean protecting, strengthening and expanding DB pension coverage.[37] A greater focus on increasing the number of retirement plans which guarantee a lifetime income stream "will play a significant role in reducing the retirement vulnerability of retirees in the future."[38]

Although DC plans have their place in retirement savings, they are only one leg of the three-legged stool. They cannot be allowed to be the only leg besides social security. DB plans have a distinct advantage over DC plans in maximizing retirement savings – so why would you not work to use the best tools to achieve a secure retirement?

What is to be done?
First, recognize the challenge and understand the issues.

Second, the federal government should develop a strategic retirement security policy. The policy's goal would not be for the federal government to insure retirement security, but rather to ensure it is not inadvertently creating barriers to the strengthening of the three-legged stool.

Third, as a society, whether in conjunction with a federal initiative or not, there needs to be increased focus on retirement savings and an increased focus on the importance of a guaranteed lifetime income stream.[39]

Fourth, we need to revisit the rules for DB plans in order to reduce the legal and administrative red tape and expense. DB plan rules can be amended to reduce volatility in employer contribution rates. DB plans can be pooled for employer types. More multi-employer plans can be created for an industry. This will create a form of DB portability heretofore unknown.

Fifth, recognize that the alternative to a too costly DB plan is a redesigned DB plan, not a DC plan. Plan designs need to be affordable for the long-term. Employers should be able to fund their plans at a reasonable cost. Employees have a vested interest in the success of these plans and should always be required to contribute a portion of their pay.

Sixth, recognize that DC plans, such as 401(k)s, are not the answer. They become a partial solution for higher paid workers with more discretionary income – they become a superb vehicle for the third leg of the stool – personal savings. But by their nature and the nature of investors, they will not provide retirement security for the vast majority of retirees.

I hope this paper has both educated and provoked thought. DB plans are and will remain crucial to the financial independence of tens of millions of retirees. IMRF's goal is to ensure DB plans flourish in both the public and private sectors.

Endnotes

[1] Illinois Compiled Statutes, 40 ILCS 5/7-102

[2] Illinois Constitution, Article XIII, Section 5
"Membership in any pension or retirement system in the state, any unit of local government or school district or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."

[3] Illinois Compiled Statutes, 40 ILCS 5/1-101.2; 40 ILCS 5/1-109

[4] **Survival Probabilities of 65-Year Olds***

Percentage Surviving to Age Shown			
Age	**Male**	**Female**	**Joint****
70	88%	93%	99%
75	73	82	95
80	55	68	85
81	51	64	82
84	38	53	71
85	34	49	66
90	16	28	39
95	5	11	15
10	1	2	3

*Human Mortality Database, University of California, Berkeley (U.S.A.), and Max Planek Institute for Demographic Research (Germany). Survival rates are based on 1999 U.S. population experience and do not reflect the expectation that people will live even longer than in 1999.
**At least one member of a couple.

[5] Alicia H. Munnell, Maurico Soto, Jerilyn Libby and John Prinzivalli, *"Investment Returns: Defined Benefit vs. 401(k) Plans,"* An Issue Brief Center For Retirement Research, September 2006, Number 52.

[6] John G. Kilgour, *"The Debate Concerning State and Local Pension Plans,"* World At Work Journal, Second Quarter 2007.

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