The Reality of Illinois' Public Pension Systems:

Pulling Back the Curtain on the Defined Benefit vs. Defined Contribution Debate!

Friday, June 20, 2008
The Business and Civil Council of Oak Park

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Public Sector Pensions

- Currently the vast majority of Illinois' Public Sector employee pensions are designed as a defined benefit system.
- Under a defined benefit system the employer guarantees an annual retirement payment for their worker that is based on a formula.

Defined Benefit Systems

- The defined benefit formula usually involves factors such as an employee's years of service, age at retirement, and either ending salary or average salary over the last few years of service.
- These benefits are funded from three sources: (i) employee contributions, (ii) employer contributions; and (iii) investment earnings
- Individual accounts are not created. Instead, all funds are pooled and the assets collectively managed

A Recent Push for Defined Contributions

- In contrast to a defined benefit plan, a defined contribution plan offers no guaranteed benefit on retirements.
- Instead it creates a retirement savings account for each member.
- The ultimate retirement benefit is the accumulated value of an individual's account at retirement, resulting from his/or her own contributions and investment returns.
- Employees make all decisions about where and when to contribute as well as invest

Who benefits from a Defined Benefit to Defined Contribution conversion?

- Much of the fervor to convert to defined contribution plans comes from third party administrators, banks, insurance companies and investment firms which stand to make vast amount of money at the expense of taxpayers and public employees.

Lets look at the Illinois Municipal Retirement Fund (IMRF):

- Currently all IMRF administrative expense are about 35 cents for every $100 invested.
- Third party administrators, such as VALIC, currently charge about $1.25 cents per $100 in assets to administer a defined contribution plan.
- When you invest money with VALIC, you pay both VALIC's fee plus an investment management fee.
- Investment management fees for mutual funds can range from another 95 cents to $1.25 or more.

The IMRF Example (Cont.)

- For purpose of argument, lets say the investment fees total $1.00.
- When you add VALIC's fee to the investment management fee, it will cost a public employee $2.25 per $100 invested
- If you earn 10% on your investments, the net increase will be only 7.75%.

The IMRF Example (Cont.)

- The IMRF trust currently totals more than $24.2 billion.
- Two dollars twenty cents ($2.25) per $100 of assets equal $544.5 million.
- Currently, IMRF pays $84 million for both administrative and investment expenses.
- **So, it would seem the Defined benefit vs. Defined Contribution debate is really a question of who gets to keep $ 460.5 million: the investors (IMRF employee and employers) or Wall Street?**

Harsh Reality of Defined Contribution Systems!

- **A defined contribution system will cost states and local governments MORE money than the current defined benefit system.**
- Defined contribution systems have significantly higher annual administrative costs than defined benefit systems.
- According to the Investment Management Institute, the operating expense ration for defined benefit plans averages 31 basis points (31 basis points) (31 cents per $100 of assets); the average for defined contribution plans is three to six times higher at 96 to 175 basis points.

Despite increased costs, Defined Contribution System offer lower benefits!

- Defined contribution systems can be expected to generate significantly lower retirement benefits for greater costs.
- This was the specific experience of Nebraska, which influenced by the rhetoric surrounding defined contributions, switched some employees from their defined benefit to a defined contribution system 30 years ago.
- Nebraska recently shifted back to a defined benefit system after realizing that while their costs had tripled, retiree benefits greatly decreased.

Doesn’t the significant shift from the defined benefit to defined contribution system in the private sector demonstrate the superiority of the defined contribution system?

Absolutely Not!

- Much of the increased utilization of defined contribution systems in the private industry was caused by the passage of the Employment Retirement Security Act (ERISA).
- ERISA established standard for defined benefit plan participation, vesting, retirement, and reporting; and imposed a tax on defined benefit plans to fund the Pension Benefit Guaranty Corporation ("PBGC")
- These changes reduced or eliminated incentives to private sector employers offering defined benefit plans, and increased the liability, expense, or regulatory requirements of maintaining a private sector defined benefit plan.

The ERISA Effect

- As a reaction to the importance of these new standards and costs, many small to midsized private sector businesses moved away from defined benefit systems toward defined contribution systems.
- However, state and local government pension plans are not subject to ERISA regulations and amendments.
- Moreover, public plans are not required to make payments to the PGBC.
- As a result, the primary factor - ERISA - that pushed the private sector toward defined contribution plans does not even apply to state and local governments.

What about portability, isn't that a positive feature of Defined Contribution systems that the public sector should explore?

The Portability Issue!

- Unlike a defined contribution system, defined benefit systems generally are not 'portable'.
- i.e. They cannot be transferred from job to job.
- The underlying argument to every portability discussion feeds on the fear of job security and the notion that people change jobs more frequently than before.

However, how big of an issue is portability for public employees?

- Many large private firms have downsized.
- But as responsibility for social services shifts from federal to state and local government, will there be the same opportunity to downsize local government?
- What does government do? It provides personal services. It does not mass produce commodities.
- Can technology replace 30%, 40%, 50% of the teachers, police officers, fireman and all other public employees at the local level?
- Probably Not!

The Portability Issue (cont.)

- What about mobility? Do public employees crave the ability to take their pension system with them to new jobs? No!
- The fact of the matter is public servants do not hop from job to job like most private sector employees.
- A teacher remains a teacher for most of her life as does a policeman, most with the same state and local government.

What about unfunded liabilities, can’t a move to a defined contribution help lower that debt?

- NO!
- Illinois’ state and local government’s unfunded pension liability cover benefits already earned by current employees and retirees.
- Changing pension systems for new employees won't reduce that debt by a penny.

A defined benefit system can actually serve to lower taxpayer cost!

- In the defined contribution setting, investment returns belong solely to an employee who makes the investment in his or her retirement account, and are not available to reduce the employer contribution.
- Fully funded defined benefit plans attain high enough investment returns that public sector employers are able to reduce the amount of normal cost paid from tax collections, freeing taxpayer revenue to cover services.
- Example—the Illinois Municipal Retirement Fund (IMRF). As of December 31, 2007, IMRF was 100 percent funded on an actuarial basis, because of this, the contribution rates fell from an average 10.4 percent in 2006 to 9.72 percent in 2007, saving taxpayers millions

The Data are clear:

The current defined benefit system is the far superior system for the public sector!