Public Employee Retirement System Frequently Asked Questions:

Q. What is a defined benefit system?

A. Under a defined benefit plan, the employer guarantees an annual retirement payment for their worker that is based on a formula. The formula usually involves factors like an employee's years of service, age at retirement and either ending salary or average salary over the last few years of service. This annual retirement payment benefit is guaranteed for the life of the member and his or her spouse. These formula determined retirement benefits are funded from three sources: (i) employee contributions; (ii) employer contributions; and (iii) investment earnings on pension fund assets. Unlike the defined contribution setting, individual accounts are not created. Instead, all employer and employee contributions and investment returns are pooled, and the assets are collectively managed. The employer maintains responsibility for managing the plan and for ensuring adequate funding is available for payment of benefits when due. Each of Illinois' five state retirement systems are primarily structured as defined benefit plans.

Q. What is a defined contribution system?

A. In contrast to a defined benefit plan, a defined contribution plan offers no guaranteed benefit on retirement. Instead, it creates a retirement savings account for each member such as under a 401(k), 403(b) or 457 plan. The ultimate retirement benefit is the accumulated value of an individual's account available at retirement, resulting from contributions made to an individual account by the participant and his or her employer, increased by investment earnings and decreased by losses. The employee is responsible for investing his or her own retirement account, but must pay a third party to administer it. Employees make all decisions about where to invest retirement savings and how much to contribute. All market and timing risks concerning the assets in an individual's defined contribution account are assumed by the employee. It is therefore possible for him/her both to outlive the accumulated assets in the account, and/or to lose all of it in a turbulent market.

Q. Why are some calling for Illinois to switch from a defined benefit to defined contribution system?

A. Currently, Illinois faces a $40.7 billion unfunded pension liability, one of the largest in the nation. Calls have been made to switch Illinois from its current defined benefit system to a defined contribution system due to misunderstandings regarding the sources of this large debt and the effects of a system switch. While employees have always contributed to their retirement system and the systems have enjoyed above average investment returns, state employers have continuously failed to contribute to Illinois' five pension systems for the last 30 years. Unfortunately this failure to contribute coupled with the fact that any funding shortfall must be paid back with interest has led to this monstrous pension debt. Additionally, already promised benefits are constitutionally protected, thus a switch to a defined contribution system would only apply to new employees (at a higher cost to taxpayers as explained below) and cannot in anyway erase the $40.7 billion unfunded liability which would still need to be paid.

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Q: Aren't public employee pension benefits extravagant?

A. **No.** Public employee annuities are quite modest. The average annual pension benefit for a retired public employee is approximately $16,488 per year. In Illinois that number is $17,112 per year, which includes the 28% of Illinois employees not covered by Social Security who rely solely on their pension for retirement income.

Q: Aren't defined benefit pension systems a financial burden to taxpayers?

A. **No.** Employee contributions and investment earnings cover the bulk of defined benefit costs, while government contributions only cover 26% of the total costs. In Illinois, investments earnings accounted for nearly 65% of all Teachers Retirement System (TRS) funding last year; in addition, the TRS employee contribution rate of 9.4% is the highest in the nation among public pension systems for teachers.

Q. Aren't defined contribution investment returns better than defined benefit investment returns?

A. **No.** Defined contribution investment returns are far below defined benefit plans' typical returns. Rates of return for professionally managed defined benefit plans outperformed employee-directed defined contribution plans by about 4% yearly during the 2000 to 2002 markets. In Nebraska, state officials felt that contributing to a defined benefit plan was a more efficient use of taxpayer money than contributing to individual defined contribution accounts, which only yielded 25% of pre-retirement income for plan members. Defined benefit plan participants were topping this by quite a lot, getting 60% to 70% of pre-retirement income.

Q. Aren't defined contribution plan fees and expenses lower than those of a defined benefit plan?

A. **No.** A defined contribution plan has an average $1.35 mutual fund charge for 'load' and administrative expenses on every $100 invested, plus additional record keeping and participating education costs. This amounts to an annual cost of 2% of invested assets. This is ten times higher that the cost of administering a defined benefit plan.

Q. Aren't all defined benefit retirement systems severely underfunded?

A. **No.** According to the Public Fund Survey, the average funded ratio for more than 100 of the nation's largest public pension plans was 87% in 2005, with two thirds of the plans at least 80% funded. Of course, some retirement funds show a large, unfunded liability, but the shortfall isn't because of employees' failure to contribute - they do. Rather, it's from the governmental failure to consistently fund these plans. Illinois' large unfunded pension liability is due to 30 consecutive years of underfunding the state retirement systems not an inherent problem with defined benefit systems.

Q. Aren't all private sector employers eliminating their defined benefit plans?

A. **No.** Much of the increased utilization of defined contribution systems in private industry was caused by the passage of the Employment Retirement Income Security Act ("ERISA"). ERISA established standards 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. As a reaction to the importance of these new standards and costs, many small to mid-sized private sector businesses moved away from defined benefit systems toward defined contribution systems.

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However, state and local government pension plans are not subject to most 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. Interestingly, even after the ERISA motivated shift to defined contribution systems in the private sector, costs of moving to a defined contribution system were so much higher than the potential tax burden under ERISA, large, private businesses predominantly continued to use defined benefit systems. Fully about 75% of the Fortune 500 still use defined benefit plans as their main retirement benefit system. Public sector employers are typically large employers. If large employers in the private sector still favor defined benefit systems despite the added costs and administrative burdens imposed by ERISA, there seems to be no reason for the public sector, which does not have those costs and burdens, to abandon defined benefit systems.

Q. Don't employees prefer defined contribution plans?

A. **No.** When given the option of switching to a defined contribution plan, workers overwhelmingly elect to stay in their defined benefit plan. In Florida and Michigan, more than 90% of those eligible to switch to a defined contribution plan stayed with the defined benefit plan. A similarly small number of Ohio's public employees enrolled in the state's defined contribution plan when that option was recently made available. Benefit experts agree that defined benefit plans are far superior to defined contribution plans for employees.

Q. Who would have the power to switch Illinois public employees from a defined benefit to defined contribution system?

A. There can be no DC plan as a substitute for a DB plan without action by the General Assembly. Under the Illinois Constitution (Article 13, Section 5) no current employee participating in a DB Plan could be forced to join a DC plan. Only new hires. A current employee could be *offered* the opportunity to switch to a DC plan on a voluntary basis, pursuant to a change in the Pension Code. For example, when SURS instituted their DC plans, incumbents could elect to join those plans on a *voluntary* basis. The amendment to the Pension Code provided a provision where a "balance" from the DB plan was calculated and moved over to the DC plan. That "balance" included both actual employee contributions and assumed employer contributions. There was a window period to make the switch. A second tier of (lower) benefits could be legislated for new hires, it could be DC or DB (or both!) that also would be up to the General Assembly.

Q. What is a funded ratio?

A. The funded ratio places the unfunded liabilities in the context of the retirement system's assets. Expressed as a percentage of a system's liabilities, the funded ratio is calculated by dividing net assets by the accrued liabilities. The result is the percentage of the accrued liabilities that are covered by assets. At 100%, a fully funded system has sufficient assets to pay all benefits earned to date by all its members. Of course, in order to calculate the funded ratio, the accrued liabilities must be calculated and the actuarial value of plan assets must be determined. A funded ratio below 80 percent is generally considered cause for concern. Illinois current funded ratio is 60.5 percent.

Q. What is the source of Illinois burgeoning unfunded pension liability?

A. At the end of FY 1995, Illinois retirement systems' total unfunded liabilities were almost $19.5 billion. By the end of FY 2006, unfunded liabilities totaled $40.7 billion. According to the Illinois Commission on Government Forecasting and Accountability, the failure to make employer contributions

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at a normal-cost-plus-interest level over the ten year reporting period has been the most significant catalyst in the increase in unfunded liabilities of all five State-funded systems.

Do you have questions about public employee retirement systems?
Submit your questions to:
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