

**ILLINOIS PUBLIC PENSION FUND ASSOCIATION  
(IPPFA)**

**POSITION PAPER  
ON  
THE SELF MANAGED PLAN OPTION**

**May, 2001**

## EXECUTIVE SUMMARY

During the last legislative session, Article 3 of the Downstate Police Pension Fund was amended to add a Defined Contribution Alternative (the “Self Managed Plan) to the existing Defined Benefit plan.<sup>1</sup> The simple fact is that this amendment is an attempt to convert the existing Defined Benefit Plan to some form of Statewide Defined Contribution Plan.

The current Defined Benefit plan provides guaranteed benefits at a surprisingly low cost to most municipalities. Unlike many Defined Contribution plans, but similar to most Defined Benefit plans, the existing program does not provide employee direction of investments, early vesting in guaranteed lifetime benefits (it takes eight years), or any lump sum distribution at retirement.

However, the current Defined Benefit program unlike the suggested Defined Contribution alternative, provides a guaranteed income stream to career employees, survivor benefits to the families of those police officers who gave their lives in public service, and inflation protection through automatic cost-of living increases.

No one doubts that employee direction of some retirement assets may be desirable as an adjunct to a reliable and guaranteed Defined Benefit plan. Participant direction is available to many police officers now through their participation in municipal sponsored 457 plans which are managed by third party administrators. These plans could be enhanced or mandated as an additional source of retirement income protection.

Moreover, the existing Defined Benefit plan could be altered to provide earlier vesting in employer contributions upon withdrawal, increased survivor benefits and inflation protection, and lump sum options at retirement. Except for the lump sum option (which can be achieved through an actuarial reduction to the scheduled retirement benefit), these alterations would have a cost. They have a cost whether they are part of the existing Defined Benefit program or come with the alternative Defined Contribution option.

Simply,

$$\mathbf{Benefits = Contributions + Investment Earnings - Expenses.}$$

This is an equation that is always and everywhere true and cannot be avoided by changing plan designs.

The fact is that higher benefits can only be achieved by higher contributions, greater earnings or reduced administrative expenses. There is no other way.

Those who promote conversions to a Defined Contribution plan by arguing that benefits will be larger are relying on unreasonable assumptions. They theorize that governmental

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<sup>1</sup> 40 ILCS 5/3-105.2, 3-109.2 and 3-109.3

Defined Contribution participants—who have no advantages relating to company stock or profit sharing—will do as well as other investors in the markets and that acceptable retirement benefits will be available by these employees’ consistently superior investment success. This idea contains the seeds of grave danger for future retirees and taxpayers.

In sum, abandoning the guarantees of the existing Defined Benefit Program is unnecessary to achieving any of the outcomes urged by the Defined Contribution proponents and could well be a serious disadvantage to future police officers.

No one would deny that the existing Defined Benefit program could be improved. In the areas of individual investment direction, vesting, and improved survivor benefits, many opportunities exist for enhancing the existing retirement structure.

## **RECOMMENDATIONS**

**With this in mind the IPPFA offers the following recommendations to the legislators.**

- **Acknowledge that Defined Benefit and Defined Contribution plans each have attractive attributes and fundamental drawbacks, and that neither provides a superior cost/benefit structure under all circumstances.**
- **Agree that the most desirable objective is to encourage personal responsibility by plan participants, while maintaining a reliable and predictable income replacement in retirement.**
- **Recognize the need that public safety officers have for ancillary benefit protection throughout their careers through well designed disability and survivor income coverage.**

## **CONCEPTUAL MISUNDERSTANDINGS**

To begin, it may serve some purpose to address some so-called “truisms” which are either erroneous or at best incomplete.

- **“Defined Contribution plans are less expensive than Defined Benefit Plans.”**

This is simply false. While generally it is not true that either plan type is more or less expensive than the other, Defined Contribution plans are generally more expensive than Defined Benefit arrangements. Interestingly, the general feeling is quite the opposite. This perception exists because of who is paying the bills. Since municipalities are usually the ones urging for a change, for many of them the Defined Contribution plan may be

cheaper.<sup>2</sup> In a Defined Contribution plan, the employee pays the costs. In a Defined Benefit Plan, the costs (subsidized by retention of employer contributions for participants who leave early in their career) are absorbed in the plan's overall performance and, to the extent necessary for sound actuarial funding of contractual benefits, must be paid by future employer contributions.

The indisputable fact is that, no matter who pays the investment costs, under any retirement program, the benefits cannot exceed the following equation:

$$\mathbf{Benefits = Contributions + Investment Earnings - Expenses}$$

Expenses are generated by two major sources—investment management expenses and expenses of administration. Expenses are less in Defined Benefit plans, in general, because all accounts are aggregated and enjoy economies of scale. Account administration can be more or less expensive in either plan, depending upon the options offered to participants.

- **“Defined Contribution Plans create greater wealth for the participants.”**

This may be partially true. Some Defined Contribution plans may provide large investment returns for the participants. But the above equation still holds. No plan can pay out any benefits greater than the sum of the contributions plus investment earnings less expenses.

The recent stock market activity shows the overall volatility of “placing all your eggs in one basket”. Historically unprecedented rates of return have been followed by a sharp downswing in investment performance. While it may be true that a snapshot at any point in time can produce favorable comparisons from either camp, the simple fact is that the average gross investment return is the same for all investors, regardless of the plan type chosen. Given identical funding and investment strategies, only a difference in the expense management will affect the investment results. To assume that Defined Contribution plans will outperform Defined Benefit Plans simply by their nature is a fallacy. In fact, since Defined Contribution plans, as stated earlier, generally have higher expense charges than Defined Benefit plans (because it is more expensive to maintain and manage thousands of individual recordkeeping and investment accounts, rather than one large institutional account) it is more likely that Defined Benefit Plans will produce greater investment results.<sup>3</sup> When considered over time, with comparable funding and investment choices, Defined Contribution plans do not magically create more wealth.

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<sup>2</sup> This is certainly true for many municipalities who are not very well funded and especially true for municipalities who have just established programs under Article 3. The contributions for municipalities with well funded police plans will be noticeably *increased* above current levels.

<sup>3</sup> Although the impact of expenses on ultimate retirement benefits is dependent on many factors, a good rule of thumb is *that a 1% increase in expenses during the accumulation period can reduce the final retirement benefit by 20% to 30%*.

- **“Implementing a Defined Contribution Plan will eliminate unfunded liabilities.”**

This again is not true. What is true is that, by design, Defined Contribution plans do not create unfunded liabilities because they do not promise future benefits nor do they reward past service. Simply, what the municipality contributes to a given participant’s account on each payday is the sum total of the municipality’s responsibility to that employee—forever. But, by the same token, neither can establishing a Defined Contribution plan eliminate the unfunded liability of the Defined Benefit plan. It would neither increase the contributions to the Defined Benefit plan nor decrease the future obligations for benefits already promised.

In fact, the establishment of the Defined Contribution plan could have the opposite effect on ongoing contributions. Consider the effects on the existing Defined Benefit program if newly hired, younger officers choose to “opt out”. If fewer participants enter the program, then the average age of the group will begin to rise but, more importantly, fewer dollars will be coming into the program. The existing pensioners will have a smaller support group and more money will be going out with less coming in as compared to the current structure. We call this the effects of anti-selection. Funds will begin to be less well funded, and since there is a mandate that all funds be 100% funded by 2033, municipalities, as the balancing entity, will need to increase their contribution levels in order to maintain the current system.<sup>4</sup> Since the Defined Benefit system is larger and contains older participants, the increases may become more substantial than the offset savings realized by the contributions to the perceived less expensive Defined Contribution plan.

- **“Given a choice, employees will always choose a Defined Contribution Alternative.”**

This is not true. The best alternative for employees is to have both a Defined Benefit and a Defined Contribution Plan. This is because in many ways the plans are complementary. Where a Defined Benefit plan may require longer vesting, less flexibility and no individual control over investments, it provides a solid guaranteed lifetime benefit. A Defined Contribution plan, while providing no guarantees, provides an opportunity to share in the long-term appreciation of investment alternatives, to exercise self-management through individual choices, and to customize retirement planning for individual family needs. Neither plan provides all the answers, and both have their shortcomings. Together, however, they provide the best of both worlds for the majority of employees. In fact, most municipalities currently offer a type of Defined Contribution plan, known as deferred compensation, to their employees by means of a voluntary supplemental plan under Internal Revenue Code section 457.

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<sup>4</sup> It is unlikely, and perhaps illegal, for contributions for participants to be increased without an accompanying increase in benefits.

**“Defined Benefit plans provide no portability for employees.”**

Limited portability is one of the well-known drawbacks to Defined Benefit plans. Under a Defined Benefit program, workers who stay with the same employer retire with larger pensions than similarly compensated workers in similar defined benefit programs who change employers over the course of their careers. The fundamental design of the current Defined Benefit plan encourages employees to stay on the job. Changes in benefit accrual rates after 20 years of service but before 30 years are intended to influence the retirement decision. Similarly, plans with absolute caps on benefit accruals such as present in the current scheme are designed to stimulate older workers’ withdrawal.

Whether public employees need portability as much as the Defined Contribution advocates claim is a point of debate. According to Labor Department statistics, public sector employees have lower turnover than private sector employees and so portability may not be as important as in the private sector.<sup>5</sup>

Nonetheless, the recent addition of pension portability to the Downstate Police Pension Plan should once and for all put this spurious argument to rest.<sup>6</sup>

- **“Defined Contribution Plans are easier to understand.”**

While the current value of a Defined Benefit plan is not well understood during the accumulation period, the benefit delivery is clear at retirement. In contrast, while the value of a Defined Contribution plan can be ascertained simply by looking up the balance during the accumulation phase, accurately predicting what the retirement benefit will be is an impossible task.

The current value of a Defined Benefit plan, as compared to the retirement benefit formula, truly is a difficult concept to communicate and to understand. For this reason, plan participants seldom realize the value of the retirement benefit.

With a Defined Contribution plan, the opposite situation exists. The current value of the account is readily available and is typically communicated to the participant frequently. The problem occurs when a participant attempts to convert the account balance to a meaningful retirement benefit estimate. To make this conversion, a series of assumptions must be made, each with their own set of risks. The only true comparison, would be to employ a reputable life insurance company and attempt to purchase an annuity with the account. This is a difficult task and one that the average participant would seldom undertake. Beyond this calculation, since the account value is dynamic, even making a short term projection (one year prior to retirement, for example) is difficult and inaccurate.

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<sup>5</sup> Employee Tenure Summary, United States Department of Labor – News Release, USDL 00-245. “The median years of tenure for workers in the public sector was more than twice that of workers in the private sector. Government workers tend to be older than workers in private industries.”

<sup>6</sup> § 3-110.7 added by PA 90-460, § 5, effective August 17, 1997.

## CONCLUSIONS

In supporting the best interests of our members, as the legislators begin the analysis of the new Self Managed Plan option, the IPPFA recommends focusing on the following principles and ideas:

- Acknowledge that Defined Benefit and Defined Contribution plans each have attractive attributes and fundamental drawbacks, and that neither provides a superior cost/benefit structure under all circumstances.
- Agree that the most desirable objective is to encourage personal responsibility by plan participants, while maintaining a reliable and predictable income replacement in retirement.
- Recognize the need that public safety officers have for ancillary benefit protection throughout their careers through well designed disability and survivor income coverage.

### **Action steps should be taken to—**

1. Enhance the existing Defined Benefit Plan to provide for the following:
  - ◆ Options for receiving a portion of the retirement benefit as a lump sum. These changes could include:
    - Taking a reduced monthly benefit in return for an immediate lump sum payment
    - Taking a reduced monthly benefit in return for making a lump sum available to a survivor upon a police officer's death.
  - Prior legislative deliberations regarding the Deferred Retirement Option Program (“DROP”) should be reconsidered.
  - ◆ Allowing terminating employees to withdraw their own funds with current prescribed statutory interest rates plus some portion of the municipal contributions made on their behalf, specifying a graduated vesting schedule for full vesting in municipal contributions.
2. Eliminate the Self-Managed Plan option from the Downstate Police Pension Fund by enhancing, or even better, replacing the current individual municipal 457 programs with a Statewide sponsored plan which will leverage the economies and efficiencies through broader coverage. In either event, the State should mandate at least a minimal employer match to encourage employees to demonstrate personal financial responsibility through increased participation in a 457 plan and most certainly eliminate any ***irrevocable*** choices for participation.