



Fundamentals

DB/DC Vol. 1 No. 1

Illinois Municipal Retirement Fund Employee Member Special Edition

Spring 1997

Defined Benefit vs. Defined Contribution

New legislation initiates debate

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This special edition
of *Fundamentals*
highlights the growing
debate surrounding
defined benefit and
defined contribution
retirement plans
(often referred to as
"DB versus DC").

Legislation was recently introduced to the Illinois General Assembly seeking to replace defined benefit plans (like IMRF) with defined contribution plans for *newly hired employees*. (See story below for details on the two types of plans.)

Although that legislation has died, the issue is still being debated and, we believe, the idea is still very much alive.

As a result, we believe it is important to provide you with as much information as possible about both sides of this debate and to inform you of the effects similar legislation could potentially have on your retirement, should it become law.

IMRF here today, here tomorrow

Once you are vested for an IMRF pension (have eight or more years of service credit), you are guaranteed to receive your pension *for the rest of your life*. This is the strength of IMRF's defined benefit plan: once you're vested for a pension, you have a constitu-

tional right under Illinois law to that pension.

IMRF's mission statement reflects our commitment to providing a safe and secure retirement for our members:

To efficiently and impartially develop, implement, and administer in a prudent manner programs that provide income protection to members and their beneficiaries on behalf of participating employers.

"Income protection" is one of the most important features of the IMRF defined benefit plan. Once you begin receiving your pension, you can relax knowing that a check will arrive every month for the rest of your life.

The "three-legged stool"

IMRF acknowledges that, in today's world, your IMRF pension alone will not provide sufficient retirement income. Therefore, IMRF endorses the "three-legged stool" model of retirement planning:

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Detailing the DB/DC debate

While both defined benefit (DB) and defined contribution (DC) plans help you acquire money for your retirement, they achieve this end in two very different ways.

The plan offered by IMRF is a **defined benefit** plan, which is an example of the traditional pension plans that grew out of the 1930s and 1940s.

If you work for a school district or hospital, you may be familiar with a Section 403(b) tax-deferred annuity, if you work for some other IMRF employer, you may be familiar with a 457 deferred compensation plan. These plans function like **defined contribution** plans. However, in a pure defined contribution plan, the employer also makes contributions.

Features of defined benefit

Under a **defined benefit** plan, your retirement benefit is calculated using a formula that includes your years of service credit and salary history.

The regular IMRF formula is 1-2/3 percent of your "final rate of earnings" for each of the first 15 years of service credit, plus 2 percent of your "final rate of earnings" for each year of service credit in excess of 15 years (a different formula is applied to SLEP members). Your

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Debate

from page one

- Leg 1 Social Security & Medicare
- Leg 2 A defined benefit pension (IMRF)
- Leg 3 Personal savings and investments

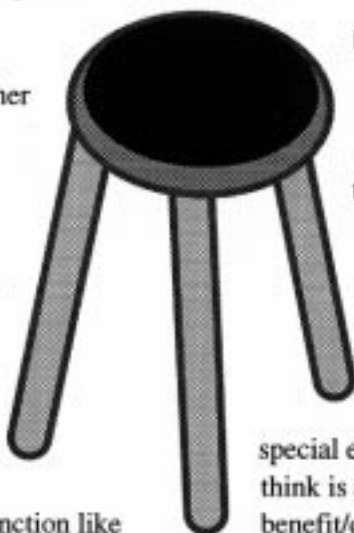
Your IMRF pension and Social Security will go a long way to ensure financial security in your retirement. But personal savings and/or investments are needed to supplement these other sources of income.

One example of *personal savings* would be your Individual Retirement Account (IRA) or an employer-sponsored Section 403(b) tax-deferred annuity or 457 deferred compensation plan. (Employees in the private sector may contribute to a 401(k).) These savings vehicles can play a significant role in your retirement planning.

The “third leg”

The personal savings plans mentioned above function like defined contribution plans and make up the third “leg” of the stool. As the third leg of retirement planning, it shouldn’t replace the other two legs, but should instead act as a single piece of your larger financial plan.

Your IMRF pension, along with Social Security, provides you with a foundation—a baseline, so to speak—for financial security. Savings from the addition of defined contribution plans can give you an additional opportunity to remain



financially independent throughout your retirement years.

Participation in a defined contribution plan can also provide you with a higher earning potential on your investments (even after you retire) so you can enjoy the better things in life.

Balance is the key to success

The “three-legged stool” approach to retirement savings provides financial stability which is dependent on all three parts. Remove one leg of the stool, and it loses that stability.

Defined contribution plans are very important to maintain your standard of living in your retirement years. But they should *not* be viewed as a replacement for the security of a pension or other defined benefit annuity. I hope you will take the opportunity to read the articles in this special edition of *Fundamentals*. We offer you what we think is an objective viewpoint on the defined benefit/defined contribution debate. The outcome of this debate will influence you and your family’s future financial security.

Educated decisions

We want you to weigh the merits and pitfalls of both plans. Members need to make educated decisions when it comes to retirement planning.

Details

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“final rate of earnings” is the average of your highest 48 months of earnings within your last 10 years of IMRF participation. Usually, this is the average of the last 48 months of service.

Not only do defined benefit plans determine your benefit by a formula, they also guarantee that the benefit will be paid for the rest of your life. The benefit payment is not dependent on whether or not contributions run out.

Your cost is fixed by law

In addition to receiving your pension for life, another advantage to a defined benefit plan is that your cost for your future pension is fixed by law. You contribute 4-1/2 percent (6-1/2 percent for SLEP) of your salary toward your IMRF defined benefit pension. However, your contributions cover only a small part (around 20 percent) of the total cost of your pension. Who pays for the rest? Your IMRF employer.

Your employer makes contributions toward your future pension as well as for your other IMRF benefits (survivor and

disability). Although your contribution rate never changes, your employer’s rate does.

The change could be the result of a number of factors; one of them is how well IMRF’s investments performed. This is what we mean when we say under a defined benefit plan, the employer “assumes all of the investment risk.” (Under a defined contribution plan, you assume all investment risk.)

When you apply for your IMRF pension, we calculate the total cost of your pension and subtract your member contributions (plus interest) from that cost. Whatever cost remains is deducted from your IMRF employer’s account. Typically, the employer pays approximately 80 percent of the cost for an IMRF pension.

Features of defined contribution

Under a **defined contribution** plan, your retirement benefit is based upon how much you contributed and the earnings made on those contributions. *please turn to page 4*

Voice your opinion on the debate ...

How can you let decision makers know your opinion on these two plans? One way is to call or write members serving on the Illinois General Assembly Pension Laws Commission. Each member's name and address is listed below, with phone numbers listed for legislators. A phone call or short letter communicating your opinion may impact your retirement or that of fellow employees down the road.

Another option is to call or write your state representative or state senator. If you need the name, phone number, or address of your legislators, you can call (217) 782-2000. For general information regarding the status of a bill, you can call the Legislative Hotline at 1-800-252-6300.

Illinois General Assembly Pension Laws Commission Members

Sen. John Maitland Co-Chairman 627-A State House Springfield, IL 62706 (217) 782-6216	Rep. Terry Deering 2065-L Stratton Bldg. Springfield, IL 62706 (217) 782-1018	Sen. Bob Molaro M103-A State House Springfield, IL 62706 (217) 782-5280	Mr. John Novak 222 S. College, Room 302 Springfield, IL 62704
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Defined Benefit Plan

Advantages

Security - The benefit formula guarantees a specific pension amount at retirement based on the member's service credit and salary history.

Market Risk - While the retirement fund invests members' contributions in the financial markets, the benefit amount is not contingent on investment returns; it is guaranteed by the benefit formula.

Simplicity - The member doesn't have to keep abreast of market conditions and trends. All investments are handled by the retirement fund.

Extra Benefits - Defined benefit plans often include disability, survivor, and health benefits. Public defined benefit plans sometimes have cost-of-living increases, such as IMRF's annual 3% increase and "13th check."

Disadvantages

Less Portable - Defined benefit plans usually require several years to qualify for any kind of benefit. Employer contributions normally remain with the plan if a member leaves employment before becoming eligible for a pension.

Rigidity - The member has no control over the investment of his or her contributions and has only a limited number of options for receiving the benefits.

Defined Contribution Plan

Advantages

Versatility - The employee has control over the investing of his or her contributions, and often controls the amount of contributions he or she pays into the plan. There are also a wide variety of choices on how the benefits can be received.

Portability - The employee may transfer all assets in the account—including employer assets—if he or she changes jobs.

Disadvantages

Uncertainty - Since the benefit amount is totally dependent on the money accumulated in the plan, there is no way to predict the future benefit amount.

Market Risk - An employee's poor investment strategies (or simply poor investment markets which the employee cannot control) can lead to low benefit amounts.

No Increases - There are, in general, no cost-of-living increases after retirement.

Longevity - The employee can outlive his or her money, or must reduce the amount he or she lives on.

Did you know these 'quick facts' about IMRF?

- ✓ You are "vested" with IMRF after eight years of service. To be "vested" means you are entitled to a pension beginning at age 55 or later.
- ✓ If you terminate employment (stop working for your IMRF employer) before you are vested, you can receive a refund of your contributions without interest and without employer contributions. However, once you become vested, all your contributions (plus interest, along with all your employer's contributions plus interest) will be used to provide a pension for life.
- ✓ In 1996, a regular member contributed 4.50 percent of his or her salary to IMRF, while the average employer contributed 9.61 percent toward a member's IMRF benefits.
- ✓ Employers also pay the *entire* cost for IMRF's death, disability, and "13th check" features. IMRF is a significant part of the compensation package furnished by your employer.
- ✓ When you retire you are guaranteed monthly benefits for the rest of your life. And your IMRF retirement benefits do not diminish over time but will actually increase at the rate of 3% of the original amount each year after you retire.

Details

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You have control over how much you contribute to the plan, as well as how the contributions are invested. However, poor investment decisions or large fluctuations in the investment markets can result in lower benefit amounts at retirement.

Employer contributions not required

Unlike a defined benefit plan, if you participate in a employer-sponsored Section 403(b) tax-deferred annuity or 457 deferred compensation plan, your employer may not make any contributions toward your retirement. The employer makes contributions


based on the type of defined contribution plan it offers.

Obviously, if the employer doesn't make contributions to the employee's retirement plan, it is the sole responsibility of the employee to contribute enough money over the course of his or her career in order to secure the maximum benefit for retirement.

Advantages and disadvantages of each

We've provided you with general overviews of both defined benefit and defined contribution plans. These overviews do not necessarily reflect IMRF or its services. Rather, they are general descriptions about the kind of services defined benefit and defined contribution plans normally offer.

In reality, every plan is different.



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Fundamentals
is published quarterly for the approximately
135,000 employee members of the Illinois
Municipal Retirement Fund.