The Case for a 100 Percent Funding Goal for a Defined Benefit Plan

The Illinois Municipal Retirement Fund (IMRF) board of trustees and staff consistently run the plan with the goal of attaining 100 percent funding status. Perhaps the simplest definition of 100 percent funding is that the assets of the retirement plan equal the benefits earned by and promised to active and retired members. When plan assets are less than promised benefits, the plan is less than 100 percent funded and has an unfunded actuarial accrued liability (UAAL).

IMRF believes 100 percent funding is the soundest long-term approach for managing its assets and liabilities for the following reasons:

- It enhances investment performance
- It provides additional assurance that promised benefits will be paid when due
- It achieves the lowest possible employer contribution rates in the long term
- It provides intergenerational equity among taxpayers
- It provides full transparency for the actual cost of promised benefits
- It complies with the Illinois Pension Code and generally accepted accounting principles (GAAP) and is consistent with the Pension Protection Act of 2006

100 percent funding enhances investment performance.

A well-funded pension plan may be better equipped to handle investment risk than a poorly funded plan, since the healthier plan has more buffer to withstand a bear market. A recent study by Fidelity Investments found that underfunded pension plans have lower investment returns than overfunded plans. One possible reason is that an underfunded plan has less flexibility in its asset allocation since it has fewer assets to meet its liabilities. For the five years ending in fiscal 2003, overfunded plans returned 5.45 percent versus 4.60 percent for underfunded plans – an 18.5 percent difference.

100 percent funding provides additional assurance that promised benefits will be paid when due.

Retirement benefits are a form of employee compensation. In exchange for an employee’s current service, an employer provides wages and other benefits such as health, life and disability coverage. In addition to these current benefits, employers often provide deferred compensation plans in the form of promised retirement benefits. These deferred retirement benefits are earned currently. So, just as an employee has the right to have his wages paid on a timely basis, he also has the right to know that his deferred benefits will be paid when they are due. Fully funding retirement plans today provides employees added assurance that funds will be available to pay their deferred compensation — their promised retirement benefits — when they become due.

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100 percent funding achieves the lowest possible employer contribution rates in the long term.

One of the popular arguments against 100 percent funding is that funding to 100 percent results in higher employer contribution rates, whereas funding at a lower percentage eases the financial burden for employers. In actuality, however, underfunding pension plans results in higher employer contributions over time. What looks like a short-term "fix" may result in a long-term financial burden.

Most public pension plans are funded from three sources: member contributions, employer contributions and investment returns. Pension benefits are determined by a formula that considers length of service and salary level. These benefits are frequently guaranteed by state law and thus are difficult to diminish. Like benefits, member contributions are generally fixed by statute and are difficult to change without a corresponding change in the related benefit.

Since pension benefits and member contributions generally are fixed, employer contributions and investment returns must balance the pension equation. Simply stated, pension benefits equal the sum of member contributions, employer contributions and investment earnings in the long term. Underfunding pension plans results in the accumulation of fewer plan assets on which to earn an investment return, necessitating larger employer contributions and higher contribution rates. To put it another way, one advantage of prefunding retirement benefits is that the ultimate cost is actually less since investment income on assets set aside to pay for future benefits will help to cover some of these future payments.

100 percent funding provides intergenerational equity among taxpayers.

Pension benefits are part of the compensation employers agree to provide to their employees. Just as periodic employee payrolls are funded currently with cash, the periodic cost of pension benefits should be funded currently. Financially sound governmental entities do not borrow long-term to meet current payroll obligations, and so financially sound governmental entities should not "borrow" long-term by not funding current pension benefit obligations.

Underfunding pension costs represents a loan from current workers to taxpayers at the current rate of return on the pension fund. However, this loan will not necessarily be repaid by the taxpayers who received the benefits of the services provided. Rather the burden of repaying the loan may well be shifted to a future generation of taxpayers. When a pension plan is systematically underfunded, future generations of taxpayers will be making contributions to pay for services provided to an earlier generation. Although underfunding pension benefits is a direct method of redistributing consumption and wealth across generations, proponents of this intergenerational tax shift seldom present it in that light.

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100 percent funding provides full transparency for the actual cost of promised benefits.

Underfunding pension plans sends the wrong economic signal to members, employers, taxpayers and policymakers since it understates the true cost of the pension benefits and may lead to providing benefits which are unsustainable over the long term. The recent pension problems in the city of San Diego, for example, can be attributed partially to the efforts of various interested parties to hide the true cost of promised benefits by deliberately underfunding their cost.

100 percent funding complies with the pension code and GAAP and is consistent with the recently enacted Pension Protection Act of 2006.

The Illinois Pension Code does not directly address the issue of funding status. However, in paragraph 5/7-172(b) 2, the Code indicates that the employer contribution rate should be adjusted to recover the unfunded actuarial accrued liability (UAAL). It states: “This adjustment shall be spread over the remainder of the period that is allowable under generally accepted accounting principles.” The governing body for generally accepted accounting principles for public pension plans is the Governmental Accounting Standards Board (GASB). In GASB Statement No. 25, “Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,” the maximum period over which the UAAL can be spread is 30 years. The accounting literature requires that the entire balance of the UAAL be amortized, which mathematically results in setting employer contributions rates designed to achieve 100 percent funding status over time.

In its 2005 policy statement entitled “Funding of Public Employee Retirement Systems,” the Government Financial Officers Association, the professional association of state, provincial and local finance officers in the United States and Canada, stated:

> “The fundamental financial objective of a state or local government employee retirement system is to establish a funding policy, and receive contributions which, expressed as a percentage of active member payroll, will remain approximately level from generation-to-generation based on the plan’s existing benefit package while fulfilling ***the long-term goal of fully funding member benefits***. Embodied in this objective are the principles of accrual accounting, which require that the ***total cost of employee services be recognized in the period in which those services are rendered***. The level contribution design of pension plan funding is intended to ***assign pension costs for the employee population to the appropriate fiscal periods***.” (Emphasis added.)

The above quote not only recommends that benefits should be fully funded, but that the cost of services should be recognized and recorded in the period they were rendered.

The recently enacted Pension Protection Act of 2006 increases the funding target for private sector defined benefit pension plans to 100 percent. Prior to this new legislation private sector plans were only required to fund up to 90 percent of a plan’s total liabilities.

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Summary

IMRF believes that its 100 percent funding goal is in the best interests of all of its stakeholders— active members, retirees, employers and taxpayers.

Investment returns are higher for fully funded pensions than for underfunded plans. Employees have added assurance that promised benefits will be paid when due if their plan is fully funded.

Failure to fully fund benefits results in lower investment earnings and higher employer contribution rates since the employer has to make up the shortfall needed to pay promised benefits. When a plan is fully funded there is no inappropriate generational cost shifting — the taxpayers who receive the services pay the cost of those services. Fully funding the benefits promised makes employers and taxpayers aware of the true cost of those benefits, and allows them to determine if the cost is sustainable.

Finally, by fully funding benefits, IMRF complies with the Illinois Pension Code.

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