

**Statement of Jon Bauman, Executive Director,  
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**U.S House of Representatives Subcommittee on Employer-Employee  
Relations**

**Field hearing on  
*“Examining the Retirement Security of State and Local Government  
Employees”***

**August 30, 2006**

Mr. Chairman and Members of the Committee, thank you for allowing me to submit written testimony to this esteemed body. My name is Jon Bauman and I am executive director of the Teachers' Retirement System of the State of Illinois.

Established in 1939, the Teachers' Retirement System (TRS) is the administrator of a multiple-employer, defined benefit pension plan. TRS provides retirement, disability and survivors' benefits to over 325,000 teachers and administrators employed at public elementary and secondary schools outside the city of Chicago.

TRS has a \$36.5 billion investment portfolio and is the largest of Illinois' five public employee retirement systems. TRS members' benefits are protected from being diminished by the Illinois constitution. However, Illinois has the unfortunate distinction of ranking among the largest unfunded pension liabilities of any state in the nation [1]. That is why I welcome the Committee's willingness to address the critical issue of retirement security.

**Funding**

The Teachers' Retirement System has three sources of funding: investment income, member contributions, and employer contributions.

A common misconception is that taxpayers, via the state and public school districts, shoulder most of the cost of funding public pension systems. To the contrary, investment income accounted for nearly 65% of all TRS funding last year [2]. TRS earned strong investment returns of 12.2% during the fiscal year ending June 30, 2006 and 9.4% per year over the past ten years. Our skillful selection of external asset managers and the diversification of our portfolio caused TRS to rank first nationally in 5-year investment performance among public pension funds of over \$20 billion, according to a recent study by the consulting firm of R.V. Kuhns & Associates [3].

TRS members provided nearly 15% of all funding in 2005. Their contribution rate of 9.4% of annual income is the highest in the nation among public pension systems for teachers. Employers, including the state and local school districts, provided just 20% of TRS funding.

The unfunded liability of Illinois' five state-funded public employee pension systems reached \$38.6 billion dollars last year. The 60 percent funded ratio is among the worst in the nation and is the result of the state's public pension funds being short-changed by the state for decades. For example, in fiscal years 1982 through 1988, state contributions dropped to approximately 60 percent of benefit payout. Subsequently, appropriations were based on the prior year's funding level, which became the de facto standard of determining state contributions.

In 1994, the state enacted a statutory payment plan designed to bring the Illinois public pension systems to a 90 percent funded ratio by 2045. The law called for contributions to be gradually increased during a 15-year phase-in period [4]. Although the first years' funding requirements of this law were met uneventfully, the early years of the 21<sup>st</sup> Century brought forth recession and investment losses to the pension systems at the same time the funding program called for larger annual funding increases that were still short of actuarial funding. A 2003 pension obligation bond issue brought the systems needed funding improvement, but did not correct the structural problems in the pension funding program.

In 2005, Illinois took steps to reign in public pension costs by approving a law that requires a dedicated revenue source to be identified for any future benefit increase. In addition, school districts are now required to pay for end-of-career salary increases over 6% used to increase pension benefits. The law, Public Act 94-0004, also requires school districts to pay for pension costs associated with granting extra sick leave. The law also eliminates a benefit calculation known as "the money purchase formula," which provided higher pension payments for some annuitants [5].

However, most of the savings achieved from the pension changes has been offset by reductions in state funding to the pension systems. The law cut funding to Illinois' five pension systems to the tune of \$2.3 billion during fiscal years 2006 and 2007. TRS alone lost over a billion dollars in state appropriations [5].

Typically, TRS has used income earned on its investments to close funding gaps. However, the recent state funding cuts have aggravated TRS's negative cash flow, requiring the System to sell \$1.2 billion in assets over the past year alone in order to make scheduled benefit payments. In addition, the reduced payments will require the state to pay steep increases in contributions to achieve the "level percent of payroll" funding by fiscal 2011, and to ultimately reach the 90-percent funding goal in 2045. TRS analysis shows that every dollar diverted from pension plans today will cost taxpayers seven dollars over the remaining forty years of the funding program. Actuarial data shows insufficient contributions is the leading cause of Illinois' unfunded pension liability [6].

**Defined Benefit Plan vs. Defined Contribution Plan**

There is a trend in corporate America and among some public pension plans to switch to defined contribution plans or a 401(k)-style program in an attempt to reduce costs.

There are two ways of comparing the costs of defined benefit and defined contribution plans. One method of comparison, which examines the administrative and investment expenses of the plan, shows that defined contribution plans are much more expensive to provide. The second way, which looks at the employer's cost of funding the benefits to be provided, shows that costs are not necessarily lower under a defined contribution plan and may in fact be higher.

Administrative and investment expenses. A public plan survey based on 2004 data that was conducted by the National Association of State Retirement Administrators and the National Council on Teacher Retirement indicates administrative costs and investment expenses for defined contribution plans are nearly five times those of defined benefit plans [7].

“The administrative cost of public defined benefit plans is substantially lower than for a typical defined contribution plan. The median cost of a defined contribution plan is approximately 1.40%; the median cost of a statewide public pension benefit is approximately 0.30%. The higher DC plan expense reduces the assets available for benefits [8].”

Costs of the benefits provided. A defined contribution plan may not reduce employer contributions for new members and may be more expensive. If new TRS members are excluded from Social Security coverage as they are under current law, the potential savings would not materialize for many years. If new TRS members were covered by Social Security, no savings are likely because the employer would also have to pay the 6.2% Social Security tax.

*Members not covered by Social Security.* Members of Illinois TRS and the Illinois State Universities Retirement System are not covered by Social Security. While most members of Illinois SURS are in a traditional defined benefit plan, some have chosen a defined contribution plan in which the employer contributes 7.6% into the account of each participant.

This 7.6% for the SURS defined contribution plan is slightly lower than the Illinois TRS employer normal cost of 8.2% of pay. The employer normal cost is a composite for members of all age and service combinations and is the amount the employer should contribute to cover the cost of benefits earned by all active employees during the year.

However, newly hired teachers have lower normal costs than the teachers making up the 8.2% composite. One reason is that new hires are not eligible for money purchase

benefits pursuant to Public Act 94-0004. Covering a newly hired TRS member under a defined contribution plan like Illinois SURS would be more expensive than the current TRS plan.

In other states, defined contribution plans not coordinated with Social Security require higher employer contributions than either of the Illinois plans discussed above. The Ohio Public Employees' Retirement System requires 9.0% and the Colorado Public Employees' Retirement Association requires 10.15% [9].

*Members covered by Social Security.* If new hires under TRS were covered by Social Security, the employer would be required to contribute 6.2% for Social Security plus a contribution to the new defined benefit or defined contribution plan.

The Illinois Municipal Retirement Fund is a defined benefit plan whose members are covered by Social Security. The employer's normal cost for regular employees under the IMRF is 7.64%, close to the 8.2% employer normal cost under TRS. Adding in the 6.2% for Social Security brings the IMRF contribution for current service to 13.84%. Under a defined contribution plan with Social Security, the total employer contribution would likely be of the same magnitude [9].

*Other observations on defined benefit and defined contribution plans.* A study conducted by Gabriel, Roeder, Smith & Company came to similar conclusions as those above. Offering defined contribution plans to newly hired employees, while keeping existing employees in an unfunded defined benefit plan, could also cost employers more in the short term [10]. The study shows by shifting new hires into a defined contribution plan, fewer active members in the defined benefit plan would be available to cover the cost of accrued benefits or the unfunded liabilities, requiring the employer contribution rate to be increased as a percentage of covered payroll.

At TRS, the percent of payroll needed to amortize the \$22 billion unfunded liability is approximately 15% of pay per year after 2010, double what normal cost will be at that time.

Defined benefit plans provide a guaranteed lifetime income to retirees. Some government employees, including TRS members, don't draw Social Security, making their defined benefit plans their only source of retirement security. Defined benefit plans employ financial experts to make investments, whereas members of defined contribution plans must rely on their own abilities to invest long term. Members of defined contribution plans are completely dependant on volatile market forces and have no guarantee of benefits when they retire.

**Conclusion**

The current unfunded liabilities of Illinois' public retirement systems were decades in the making. The biggest contributing factor is a shortfall in state funding, demonstrating that the state has consistently failed to make its public pension systems a funding priority. While converting from defined benefit plans to defined contribution plan may lower expenses over the long run, it could take decades to realize those savings. Defined contribution plans provide no guarantee of retirement security and do not solve the unfunded status of defined benefit plans.

Public policy makers must stop short-changing the pension systems in order to fund the other operations of state government. By putting off payments to the public pension systems today, the state of Illinois is strapping future generations with more debt and jeopardizing the retirement security it has ensured under the state constitution.

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**Endnotes**

- [1] Keith Brainard, *Public Fund Survey Fiscal Year 2005*
- [2] Teachers' Retirement System of the State of Illinois *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2005, page 8
- [3] RV Kuhns & Associates, Inc. *Public Fund Universe Analysis Report*, period ending June 30, 2005, pg 22
- [4] 40 ILCS 5/16-158
- [5] Illinois General Assembly Web site for P.A. 94-0004  
<http://www.ilga.gov/legislation/publicacts/94/PDF/094-0004.pdf> Section 16
- [6] Hansen Consultants, *Actuarial Valuations*, fiscal years 1985-1988, Mellon Consultants and Buck Consultants, *Actuarial Valuations*, fiscal years 1989-2005.
- [7] National Association of State Retirement Administrators and the National Council on Teacher Retirement, *Public Fund Survey on Defined Contribution Plans vs. Defined Benefit Plans*, 2004.
- [8] National Association of State Retirement Administrators, *Talking Points*,  
<http://www.nasra.org/resources/talking%20points.pdf>
- [9] Teachers' Retirement System of the State of Illinois, *June 30, 2005 Actuarial Report*; retirement system Web sites.
- [10] Carter, W. Michael, Conradi, J. Christian, Fonia, William B., *Defined Contribution Retirement Plan Study*. Gabriel, Roeder, Smith & Company. October 2005