



# The Civic Federation

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## ILLINOIS PENSION PRIMER

### *A Plain-English Guide to Public Employee Pensions in the State of Illinois*

April 22, 2015

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*The Civic Federation is an independent, non-partisan government research organization working to maximize the quality and cost-effectiveness of government services in the Chicago region and State of Illinois.*

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## INTRODUCTION

The State of Illinois' pension funds and those of many local governments in Illinois are in distress.<sup>1</sup> The landmark pension reforms passed by the Illinois General Assembly for four of the State's five funds, and three Chicago funds in 2013 and 2014 were a strong step in the right direction. However, much remains to be done.

It is imperative that Illinois continue to enact pension reform legislation, particularly for the Police and Fire pension funds in Chicago, the Chicago suburbs and downstate Illinois. The Civic Federation recognizes that it is difficult to understand the immediate necessity for reforms and their long-term implications without an understanding of how public pensions work. This plain-English guide and associated online tutorial<sup>2</sup> is intended to begin to fulfill this need. It focuses specifically on the five State of Illinois pension funds<sup>3</sup> and ten large Chicago-area pension funds.

There are also significant other post employment benefits (OPEB) obligations for the State of Illinois and many local governments across Illinois, mostly for retiree healthcare. Those obligations are outside the scope of this report.

## WHAT IS A PUBLIC PENSION?

There are two major types of retirement plans: defined benefit (DB) plans and defined contribution (DC) plans. There are also hybrid and cash balance plans that combine various aspects of DB and DC plans. In Illinois nearly all public pension plans are defined benefit plans. The following section describes the difference between the two major types of plans and looks at their prevalence in the public and private sectors.

### Defined Benefit Plans

A defined benefit plan provides workers with a benefit guaranteed to last throughout their retirement. (The **benefit** is "defined.") The benefit is determined by a formula that considers the number of years each employee served and his or her highest average pay.

In Illinois public pensions are funded through employer and employee contributions and investment earnings. The contributions are pooled in an employer-sponsored retirement fund that makes decisions on how to invest assets for all employees. If the amounts contributed to the plan plus the investment earnings are not enough to pay the promised benefit for a beneficiary, the former employer is expected to make payments to compensate for the difference.

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<sup>1</sup> Pew Center on the States, *The Widening Gap Update*, June 2012, p. 5.; Moody's Investors Service, *Illinois State and Local Governments Face Daunting Pension Challenges*, September 5, 2014, p. 2.; Pew Center on the States, *A Widening Gap for Cities*, January 2013, pp. 12-13. See also the Civic Federation's *Status of Local Pensions* reports and the Institute for Illinois' Fiscal Sustainability's Roadmaps for the State of Illinois. All Civic Federation reports available at [civicfed.org](http://civicfed.org).

<sup>2</sup> Online tutorial available at <http://www.civicfed.org/IllinoisPensionPrimer/index.html?r=61>.

<sup>3</sup> The Illinois Municipal Retirement Fund or IMRF, one of the largest funds in Illinois, is not included in this analysis nor are the 660 downstate and suburban police and fire funds.

### ***Risk***

The risk with a DB plan falls on the employer, which must make up for any shortfalls in funding whether they are caused by investment earnings less than expected, if employees live longer than expected or insufficient prior employer contributions.

### ***Portability***

A defined benefit pension plan is much less portable than a DC plan. Participants who have not served long enough to have vested<sup>4</sup> in a DB plan only receive their contributions, usually with interest. They do not receive the contributions made by the employer or any investment gains and have no right to a future benefit. Once participants are vested, if they leave government service they can choose to receive a pension once they retire from the workforce for the years they worked only or can take with them their accumulated contributions and interest.

### **Defined Contribution Plans**

A defined contribution plan combines a fixed employer contribution (the **contribution** is “defined”) with employee contributions in an individual retirement savings account. The funds in the account are generally invested according to choices made by the employee. The retirement benefit is then based on the value in the account when the worker retires.

Employees are not guaranteed a specific benefit. Either in lump sum or annuity, they receive their own total contributions and the contributions made by the employer to their account over their career, increased or decreased by investment returns or losses.

In general, the employer’s obligation ends upon the employee’s retirement, apart from any promised retiree health benefits. Common examples of defined contribution plans are 401(k), 403(b) and 457 plans. These designations refer to the governing sections of the federal tax code.

### ***Risk***

The risk with a DC plan is borne exclusively by the employee. If investments do not perform, if the employee lives longer than expected or if the employee did not contribute sufficient funding, the employer is NOT obligated to make up the difference.

### ***Portability***

A defined contribution plan is almost completely portable. In the event of job change, an employee can roll over his or her account assets, including employer contributions and investment gains, into an IRA or a qualified plan of a new employer.

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<sup>4</sup> See page 9 for definition.

## Social Security and Defined Benefit Pensions

In Illinois most public employee wages are not covered by Social Security for their employment with the State of Illinois and local governments.<sup>5</sup> Among the 10 large local government pension funds in the Chicago area the Civic Federation studies,<sup>6</sup> only the participants in the Chicago Transit Authority (CTA) pension fund also participate in the federal Social Security program. CTA retirees are eligible for Social Security benefits in addition to their CTA pension benefits. The CTA and its employees each pay an additional 6.2% of the employee's Social Security taxable salary to the Social Security Administration. Among the five State funds studied in this primer,<sup>7</sup> only SERS has some members in the Social Security program.

## WHO HAS DEFINED BENEFIT AND DEFINED CONTRIBUTION PENSIONS?

In the 1970s, private sector workers and public sector workers across the United States had similar levels of access to defined benefit pensions. In 1975 88% of private sector workers and 98% of public sector workers had access to DB plans.<sup>8</sup> However, the number of private sector workers enrolled in an ongoing DB plan fell significantly to 19% by 2014. There has been a lesser decline in the public sector, where 83% of workers still have access to an ongoing DB plan.<sup>9</sup>

Many more private sector workers have access to DC plans than public sector workers. In 2014 60% of private sector workers had access to a DC plan—usually a 401(k)—while only 33% of public sector workers did.<sup>10</sup> So in general, private sector workers are more likely to have defined contribution retirement benefits and public sector workers, like those in Illinois, are more likely to have defined benefit retirement plans. This shift has been attributed to the different pressures and characteristics of employers and employees in the public and private sectors.<sup>11</sup>

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<sup>5</sup> United States Government Accountability Office, *Social Security Administration: Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees*, September 2010.

<http://www.gao.gov/assets/320/310303.pdf>.

<sup>6</sup> The 10 funds are: the Municipal Employees' Annuity and Benefit Fund of Chicago, Laborers' and Retirement Board Employees' Annuity and Benefit Fund of Chicago, Firemen's Annuity and Benefit Fund of Chicago, Policemen's Annuity and Benefit Fund of Chicago, County Employees' and Officers' Annuity and Benefit Fund of Cook County, Forest Preserve District Employees' Annuity and Benefit Fund of Cook County, Metropolitan Water Reclamation District Retirement Fund, Retirement Plan for Chicago Transit Authority Employees, Public School Teachers' Pension and Retirement Fund of Chicago and Park Employees' & Retirement Board Employees' Annuity and Benefit Fund.

<sup>7</sup> The State Employees' Retirement System (SERS), the State Universities Retirement System (SURS), the Teachers' Retirement System (TRS), the General Assembly Retirement System (GARS) and the Judges' Retirement System (JRS).

<sup>8</sup> Center for Retirement Research, "Why Have Defined Benefit Plans Survived in the Public Sector?" December 2007, p. 2.

<sup>9</sup> Bureau of Labor Statistics, National Compensation Survey, Employee Benefits Survey, Retirement Benefits, "Retirement Benefits: Access, participation and take-up rates," March 2014.

[http://www.bls.gov/ncs/ebs/benefits/2014/benefits\\_retirement.htm](http://www.bls.gov/ncs/ebs/benefits/2014/benefits_retirement.htm)

<sup>10</sup> Bureau of Labor Statistics, National Compensation Survey, Employee Benefits Survey, Retirement Benefits, "Retirement Benefits: Access, participation and take-up rates," March 2014.

[http://www.bls.gov/ncs/ebs/benefits/2014/benefits\\_retirement.htm](http://www.bls.gov/ncs/ebs/benefits/2014/benefits_retirement.htm)

<sup>11</sup> A report by the Center for Retirement Research at Boston College concluded that, "the reasons for these divergent trajectories reflect the different nature of the public sector workforce — older, more risk averse, less mobile, and more unionized; the different nature of the public employer — a perpetual entity facing fewer market pressures; and

## HOW MANY PUBLIC PENSION PLANS ARE THERE IN ILLINOIS?

According to the Illinois Department of Insurance, there are 675 pension plans in Illinois, of which 15 are “large” funds like the ones covered in this report and 660 are downstate and suburban municipal police and firefighters’ funds.<sup>12</sup>

The Department of Insurance also reports that in 2012 the assets held by all pension systems in Illinois was \$138.7 billion. The 675 systems cover more than one million people with over 605,000 active participants and 438,800 retirees, surviving spouses and other beneficiaries. All pension funds in Illinois paid out total benefits of \$14 billion in 2012.<sup>13</sup>

## HOW DOES A DEFINED BENEFIT PENSION WORK?

In order to understand how a defined benefit pension works, it is important to understand several crucial terms and how to calculate a pension benefit.

### How to Calculate a Defined Benefit Pension<sup>14</sup>

There are three parts of the defined benefit pension formula: final average salary, years of service and the multiplier. They are multiplied together to calculate the base annuity for a retiree.<sup>15</sup>



### Definitions of Major Terms Used in Pension Calculation

The following are plain-language definitions of the pension formula terms. For more technical definitions, see the Civic Federation’s *Status of Local Pensions* reports, available at [civicfed.org](http://civicfed.org). Additional terms associated with evaluating the fiscal condition of pension funds are described in the following sections.

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a different regulatory environment — free from the administrative costs and vesting requirements of ERISA, with the ability to adjust employee contributions to control the employer’s costs.” Center for Retirement Research, “Why Have Defined Benefit Plans Survived in the Public Sector?” December 2007, p. 6.

<sup>12</sup> Illinois Department of Insurance, *Annual Report to the Governor 2013*, p. 34. Available at <http://insurance.illinois.gov/Reports/AnnRept/2013AnnualRptToGovernor.pdf>.

<sup>13</sup> Illinois Department of Insurance, *Annual Report to the Governor 2013*, p. 34. Available at <http://insurance.illinois.gov/Reports/AnnRept/2013AnnualRptToGovernor.pdf>.

<sup>14</sup> Some public pension funds in Illinois have a more complicated benefit calculation, with higher multipliers for longer years of service. The formula described here is the most common.

<sup>15</sup> As described in the next section, for most plans a maximum benefit also applies. For Chicago teachers, the maximum percentage of final average salary they can get in retirement is 75%. This means that once Chicago teachers have accrued 34 years of service, they maximize the percent of their final average salary they will earn in retirement.



### ***Final Average Salary***

Most DB pension plans in Illinois use an employee's highest salary over several years to calculate a final average salary. The number of years varies significantly between plans.

For example, many Chicago funds and the state fund for teachers outside of Chicago base their final average salary on the average of the highest four consecutive years of pay within the last 10 years of employment. Other funds use shorter or non-consecutive time periods.

Using shorter time periods to calculate final average salary generally results in higher retirement benefits. This is because longer time periods take into account a wider range of employee earnings and because shorter time periods also make it easier to engage in "pension spiking" or artificially inflating pensionable salary. For a few funds in Illinois, special provisions allow workers to use their salary on the final day of employment as final average salary for the calculation of their pension benefit. The State General Assembly and Judges funds are two funds that have this very generous benefit.

### ***Multiplier<sup>16</sup>***

The multiplier (sometimes also called the "benefit multiplier," the "annual multiplier" the "service accrual rate" and the "benefit factor") is another part of the formula used to calculate a DB pension. The multiplier is the percent of final average salary earned per year of service. So the larger the multiplier, the greater the retirement benefit that accrues per year.

The amount of the multiplier varies among funds. It tends to be lower for employees who can access Social Security. It is higher for those employees without access to Social Security and for public safety employees, who may have shorter careers due to the more strenuous physical requirements of their jobs. For some funds, higher multipliers are allowed for longer years of service. In a survey of state and local pension plans, the typical multiplier was 2.0%, with most plans clustered between 1.5% and 2.5%.<sup>17</sup> The multipliers for the State and local funds in this report range from 1.67% for SERS employees who have Social Security to 5% for Judges and General Assembly members for years of service in excess of 10 years and 12 years, respectively.

### ***Years of Service***

Years of service is the number of years for which an employee receives pensionable credit for their service. In Illinois many plans allow reciprocal benefits under which an employee transferring from one public employer to another may take their years of service with them and have them count in their new employer's pension fund.

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<sup>16</sup> The Illinois General Assembly's Commission on Government Forecasting and Accountability calls this the "retirement formula" in its analyses of state and local government pensions in Illinois.

<sup>17</sup> Alicia Munnell, *State and Local Pensions: What Now?* 2012, pp. 28-29.

To illustrate, a Chicago teacher who has attained age 60, whose four highest consecutive years of salary in the past ten years averaged \$88,500 and who worked for 24 years would receive an initial benefit of \$46,728.<sup>18</sup>

The diagram consists of four blue rounded rectangular boxes arranged horizontally. The first box contains '\$88,500', the second '24 years', the third '2.2%', and the fourth '\$46,728'. Multiplication symbols (×) are placed between the first and second boxes, and between the second and third boxes. An equals sign (=) is placed between the third and fourth boxes.

### ***Vesting***

Employees do not become entitled to receive a pension on their first day of service. For most funds in Illinois, there is a minimum number of years they must serve with a government before they are entitled to receive more than a return of their contributions plus interest if they leave employment with the government. Nationally, the vesting period ranges from three to 10 years with a median of five years of service.<sup>19</sup>

### ***Tier 1 and Tier 2 Employees***

For most public pensions in Illinois, workers hired before January 1, 2011 qualify for a higher level of benefits than those hired on or after that date. To read more about the pension reform package passed in 2010 that created a separate tier of benefits for new employees, see page 34.<sup>20</sup>

**Tier 1** refers to the original package of benefits.

**Tier 2** refers to the new, less generous package of benefits for public employees hired on or after January 1, 2011.

### **How Does a Pension Benefit Grow after Retirement?**

In Illinois a retiree's benefit does not remain at the base pension amount for the length of retirement. For many pension plans in Illinois, the annuity is increased annually by 3% on a compounded basis. This means that the 3% increase applies not only to the original pension amount, but also to subsequent increases.

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<sup>18</sup> The average FY2014 final salary of Chicago Public Schools teachers with 20-24 years of service (the largest retiring cohort) was \$88,512 so \$88,500 is used as an approximate final average salary. Chicago Teachers' Pension Fund 119<sup>th</sup> Comprehensive Annual Financial Report for the Year Ended June 30, 2014, p. 133.

<sup>19</sup> Robert L. Clark et al. cited in Bureau of Governmental Research, "Understanding Pensions: A Primer on Public Employee Pension Plans," p. 5.

<sup>20</sup> For CTA employees, Tier 1 employees were hired on or before January 17, 2008 and Tier 2 employees were hired on or after January 18, 2008.

### ***Automatic Annual Increase***

Automatic annual increases are generally intended to offset the impact of inflation on a retiree’s benefit. Not all annual increases are related to the actual cost of living as measured by the consumer price index, however. They are annual additions to the retirement benefit and may be a set amount or percentage or set to inflation. In other states, some annual increases are tied to investment returns or are awarded on an ad hoc basis.

The 3% compounded increase is not a cost of living adjustment (COLA) because it is not tied to the cost of living. However, it is often erroneously referred to as a COLA in public discussions. No matter whether inflation is 1% or 10%, retirees receive a 3% annual increase in their annuity. Protecting retirement benefits from inflation is very important, particularly for employees who will not receive their inflation protection through Social Security. However, the 3% compounded increase is an expensive benefit, especially in a low-inflationary environment. An employee can nearly double their annuity within 25 years, as shown in the following chart displaying the growth in the Chicago teacher’s annuity calculated above.

<b>How the Chicago Teacher's Annuity Grows with 3% Compounded Automatic Annual Increase</b>			
<b>Final Average Salary = \$88,500</b>			
<b>Base Annuity</b>	<b>\$46,728</b>	Year 14	\$68,622
Year 2	\$48,130	Year 15	\$70,680
Year 3	\$49,574	Year 16	\$72,801
Year 4	\$51,061	Year 17	\$74,985
Year 5	\$52,593	Year 18	\$77,234
Year 6	\$54,171	Year 19	\$79,551
Year 7	\$55,796	Year 20	\$81,938
Year 8	\$57,470	Year 21	\$84,396
Year 9	\$59,194	Year 22	\$86,928
Year 10	\$60,969	Year 23	\$89,536
Year 11	\$62,799	Year 24	\$92,222
Year 12	\$64,682	Year 25	\$94,988
Year 13	\$66,623	<b>Increase</b>	<b>103.28%</b>

The 3% compounded increase is fairly common in Illinois, but not nationally. According to the Public Plans Database maintained by the Center for Retirement Research at Boston College, the most common type of annual annuity increase, used by 41% of the plans surveyed, is linked to the consumer price index and usually capped at 3%. Automatic fixed rate increases that are not tied to the rate of inflation make up 35% of plans surveyed and can either be a fixed dollar amount or a fixed percentage, like many plans in Illinois. The remainder of plans have annual increases tied to investment returns (7%) or granted on an ad hoc basis (13%). Four percent do not grant any increases at all.<sup>21</sup> It is important to recognize here that, nationally, approximately 70% of state and local government workers are covered by Social Security<sup>22</sup> and thus receive their inflation protection through their Social Security benefits. Thus, some of the less generous annual annuity increases in the Public Plans Database may reflect the Social Security status of their members.

<sup>21</sup> Alicia Munnell, *State and Local Pensions: What Now?* 2012, pp. 29-30.

<sup>22</sup> Alicia Munnell, *State and Local Pensions: What Now?* 2012, p. 25.

## What are the Limitations to Pension Benefits?

Generally, there is a maximum percentage of final average salary a pension participant can earn and a certain age and years of service an employee must attain to draw a maximum pension. There are also rules for how a retiree's annuities are reduced if they elect early retirement.

### *Maximum Annuity*

For the funds examined in this report, there are limitations to the percentage of final average salary retirees can receive as their initial annuity. These limitations range from 70% to 85% of final average salary. This means that after a certain point, workers can no longer increase the percent of their final average compensation they will receive in pension benefits. Some workers in Illinois also have limitations to the amount of salary from which final average salary can be calculated. However, there are no caps in Illinois on how high a benefit can increase *after* retirement.

If a worker has a pension multiplier of 2.2%—meaning they earn 2.2% of their final average salary per year of employment—and the maximum annuity is 75% of final average salary, he or she would have to work for 34 years to maximize the percentage of final average salary received in retirement.

$$75\% \div 2.2 = 34 \text{ Years}$$

### *Retirement Age and Length of Service*

All the funds examined in this report have some kind of eligibility threshold for an employee to start receiving benefits. For most funds, it is a combination of years of service and an age threshold. However, some funds allow workers to retire at any age if they have the requisite number of years of service and some allow maximum retirement benefit when a worker's age plus years of service equal a certain number, such as 85.

For example, a Tier 1 Chicago teacher can retire with a full benefit at age 62 with at least five years of service, age 60 with 20 years of service or age 55 with 34 years of service. If he or she is a Tier 2 employee, the retirement age for a maximum benefit is 67 with 10 years of service.

Most funds also have some provisions for a reduced early retirement. That is, a worker's pension benefit is reduced by a certain amount based on the number of years or months of age that worker is below the age of retirement eligibility.

For Tier 1 Chicago teachers, the early retirement benefit is age 55 with 20 years of service, but the pension is discounted at the rate of one half of one percent for each month that the retired

teacher is less than 60 years of age. For Tier 2 teachers, a reduced early retirement is allowed at age 62 with 10 years of service.

A lower retirement age can make a pension plan more expensive, both because employees receive benefits for a longer amount of time and because workers contribute to the fund for a shorter period of time.

### ***Caps on Benefits (or Accrual of Benefits)***

Caps are limitations to the accrual of benefits under a defined benefit pension. There are several types of caps under Illinois pension law.

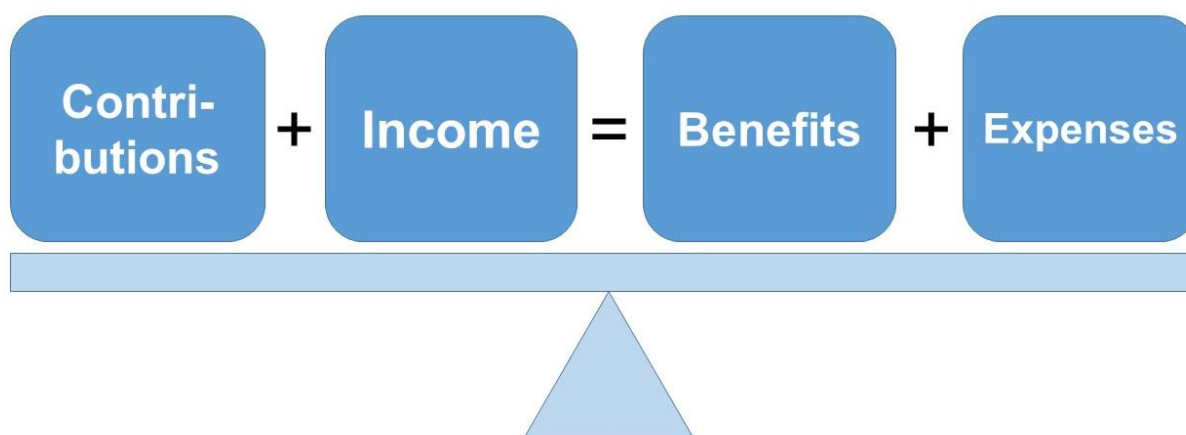
The first type is a **limitation to the percentage of final average salary an employee can accrue**. As discussed above, this means that there comes a point where an employee will not accrue a higher percentage of his or her final compensation as the initial pension benefit by remaining employed for additional years. All of the funds in this report have such caps, which range from 70% to 85% of final average salary.

Another type of limitation is in effect for Tier 2 employees of nearly all pension funds in Illinois and was a component of the pension reforms for four of five State pension funds. (See page 10 for a definition of Tier 2.) For those funds, there is a **maximum dollar cap on pensionable earnings**. That is, the dollar amount from which final average salary is calculated is capped at a certain dollar amount. For Tier 2 members, the cap started at \$106,800 in FY2011 and was increased annually by the lesser of 3% or one half of the increase in Consumer Price Index. The pensionable salary cap included in pension reforms for state employees is either equivalent to the adjusted Tier 2 cap or is their salary on the effective date of the legislation if it is higher than the cap. The latter “grandfathers in” higher salaries than the cap. These caps effectively lower the cost of pensions for high-earning public employees while not impacting those employees with lower incomes.

### **WHO PAYS FOR PENSION BENEFITS?**

As described above, defined benefit pensions in Illinois are funded through **employee contributions, employer (taxpayer) contributions** and **investment earnings**. If investment earnings fall below expectations and/or past contributions have been inadequate, current and future taxpayers must make up the difference. This is why intergenerational equity is an important consideration for pension funding. Intergenerational equity aligns the cost of public services with the taxpayers benefiting from those services. Put differently, intergenerational equity means that paying for the costs of current public employees—including pensions—should not be pushed off onto future generations of taxpayers.

The fundamental equation of pension plan financing is  $C + I = B + E$ , or Contributions (C) + Income (I) = Benefits (B) + Expenses (E).<sup>23</sup>



$C + I = B + E$  means that, over time, inflows of funding **contributions** from employers and employees along with investment **income** must **equal** outflows of **benefits** paid and **expenses** incurred to run the pension system.

The fundamental equation shows how important risk and intergenerational equity are when designing a pension funding plan and deciding how to invest its assets. The right side of the equation is fairly set. Benefits are generally fixed<sup>24</sup> or may only be changed during extreme circumstances<sup>25</sup> and expenses can be managed well, particularly in large defined benefit pension plans, due to the economies of scale that come from pooling the resources of all employees. It is the decisions made on the left side of the equation with regard to contributions and investments that largely determine how risky a defined benefit pension plan is to taxpayers. Ultimately, if too much risk is taken on by the plan, the benefits on the right side of the equation may eventually be jeopardized.

If a public employer's pension funding plan (the "C" part of the equation) is not adequate to fulfill the financial needs of the fund and/or it is not flexible and responsive enough to changes in circumstances, it is risky to taxpayers, especially future taxpayers. Since benefits cannot generally be reduced, employer contributions that do not strive to fund 100 percent of pension obligations and those that do not adjust to changes in circumstances like investment losses carry a significant risk. The risk is that past taxpayers have paid less in taxes than they should have for the benefits of the government employees who served them. As a consequence, future taxpayers could be called upon to pay significantly higher taxes in order to fund pensions for government employees who never served them. Such risk seriously compromises the intergenerational equity of a pension plan.

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<sup>23</sup> Graphic inspired by Texas Pension Review Board, *Understanding the Basics of Actuarial Methods*, April 2013, p. 2.

<sup>24</sup> Benefit design can add risk to the plan – e.g. use of final pay formulas that allow spiking. However, plans can be designed such that the benefit formula does not add additional risk.

<sup>25</sup> The Illinois Supreme Court will decide whether pension benefits for current employees and retirees can be changed in a case to be decided in 2015. See page 36 for more information about the restrictions on changing pension benefits in Illinois.

Another significant risk associated with public DB plans is investment risk. As discussed above, public pension plans invest the contributions of employees and employers to generate the majority of income for the fund (the “I” part of the equation). The expected or assumed rate of return on these investments (also known as the “discount rate”) is an important assumption that has a relationship with the amount of investment risk a fund takes, the level of funding and the employer contribution. More investment risk (that is, investing more of a pension fund’s portfolio in equities and alternative investments like real estate or hedge funds in contrast to bonds and other fixed income investments) contributes both higher *expected* returns, but also makes those returns more *volatile*. Volatility in returns creates significant downside risk for the employer that they will have to make additional contributions to make up for investment losses. And, if investment losses occur along with an economic downturn, such as happened in 2008, the sponsor may have to pay more in contributions at the same time it is facing a decline in revenues. If these additional contributions are not made immediately, but spread over many years, future taxpayers end up paying for current investment losses, impairing intergenerational equity.

However, there are also upside risks peculiar to the public sector in that high investment returns with commensurate high funding levels can create a perverse incentive for public employers to skip contributions or enhance benefits, which depletes reserves instead of stockpiling them against future expected investment losses. Additional discussion of the expected rate of return assumption and investment risk can be found in the next section.

Choices made in how to fund public pension plans and how they are invested helps to explain how the fundamental pension equation became severely imbalanced in Illinois. The following sections explore how poor choices on the C + I side of the equation have contributed to compromised intergenerational equity with regard to public pensions in Illinois.

### **Investment Returns**

A pension fund invests the contributions of employers and employees in order to generate additional revenue over an extended period of time. Investment returns provide the majority of income for an employee’s pension over the course of a typical career. The assumption as to what level of investment income the fund will earn over a long period of time is therefore a very important assumption within a pension plan. As noted above, the rate of return on investment assumption is related to the level of risk a fund takes in its investments and influences both how much an employer must make in contributions and our evaluation of how well a plan is funded.

Public pension funds generally use an investment return assumption for reporting purposes based on what the fund’s assets are expected to return over the long run. For the funds examined in this report, that expected rate of return ranges from 7.0% to 8.25%. This means that when calculating whether the fund has enough money to pay accrued benefits and what the employer contribution must be, the fund’s actuary assumes that a fund with an investment assumption of 7.0% will earn 7.0% on average from the assets in its investment portfolio over the long run. If a fund chooses a higher assumed rate of return, it has in effect chosen to invest in riskier investments with higher expected returns in order to achieve its funding target over the long-run. Riskier investments experience more volatility and therefore investment income can show large fluctuations from

year to year. Low or negative investment income can cause a significant drop in pension fund assets.

Investment losses are particularly harmful for mature funds, which have a high number of retirees compared to current employees. All of the funds examined in this report are mature. Mature funds have a significant amounts of assets, but also have a smaller pool of employees contributing to the fund and therefore a smaller base from which to replenish asset losses. This increases the risk to the employer—and therefore to taxpayers—that they will have to make larger contributions from taxes to make up for investment losses. Employer contributions tend to be budgeted as a percentage of payroll. If the fund is much larger than the covered payroll the effect of an asset loss will be to increase the contribution sharply as a percentage of payroll.<sup>26</sup>

The investment return assumption comes into play when an employer needs to know the cost of the pension benefits its employees earned this year in addition to what the benefits earned to date will cost them in the future. This is because they need to put aside enough cash now so that in the future there will be enough funding to pay the promised benefits. In order to know what the current cost of a future benefit is, the cost of the future benefit needs to be “discounted” to the present cost. State and local pension plans usually discount their future obligations by the expected rate of return on the assets held in the fund. A higher expected rate of return assumption means that the assets in the fund are expected to earn more in the future and therefore the employer is required to contribute less now to the fund. A lower assumption means that assets will earn less in the future and more funding must be set aside now so that the fund’s assets are able to earn enough over the long term to fulfill benefit obligations. However, a higher rate of return assumption involves a higher level of risk, as discussed above, and higher volatility meaning that employer contributions are more likely to be volatile as well.

Using the expected rate of return as the discount rate is standard practice for public plan funding, but does not follow economic principles. Under economic principles, the discount rate should reflect the risk associated with the pension *obligations*, not the assets. Therefore, given that public pension benefits are guaranteed under many state laws, some economists believe the discount rate should be the riskless rate, such as the rate of return on treasuries, since the obligations carry little to no risk to participants, no matter what happens to the fund’s investments. Such a rate is much lower than the expected rate of return on investment standard used by most public pension systems and would produce much higher current liabilities and employer contributions.<sup>27</sup> Which standard to use is the subject of much controversy in the public pension community, with some advocating using a riskless rate for reporting purposes only and the rate of return standard for calculating contributions, some advocating using a riskless rate for both reporting and funding and others saying the rate of return standard should be used for both funding and reporting. The funds in this report use the standard practice for public plan funding.

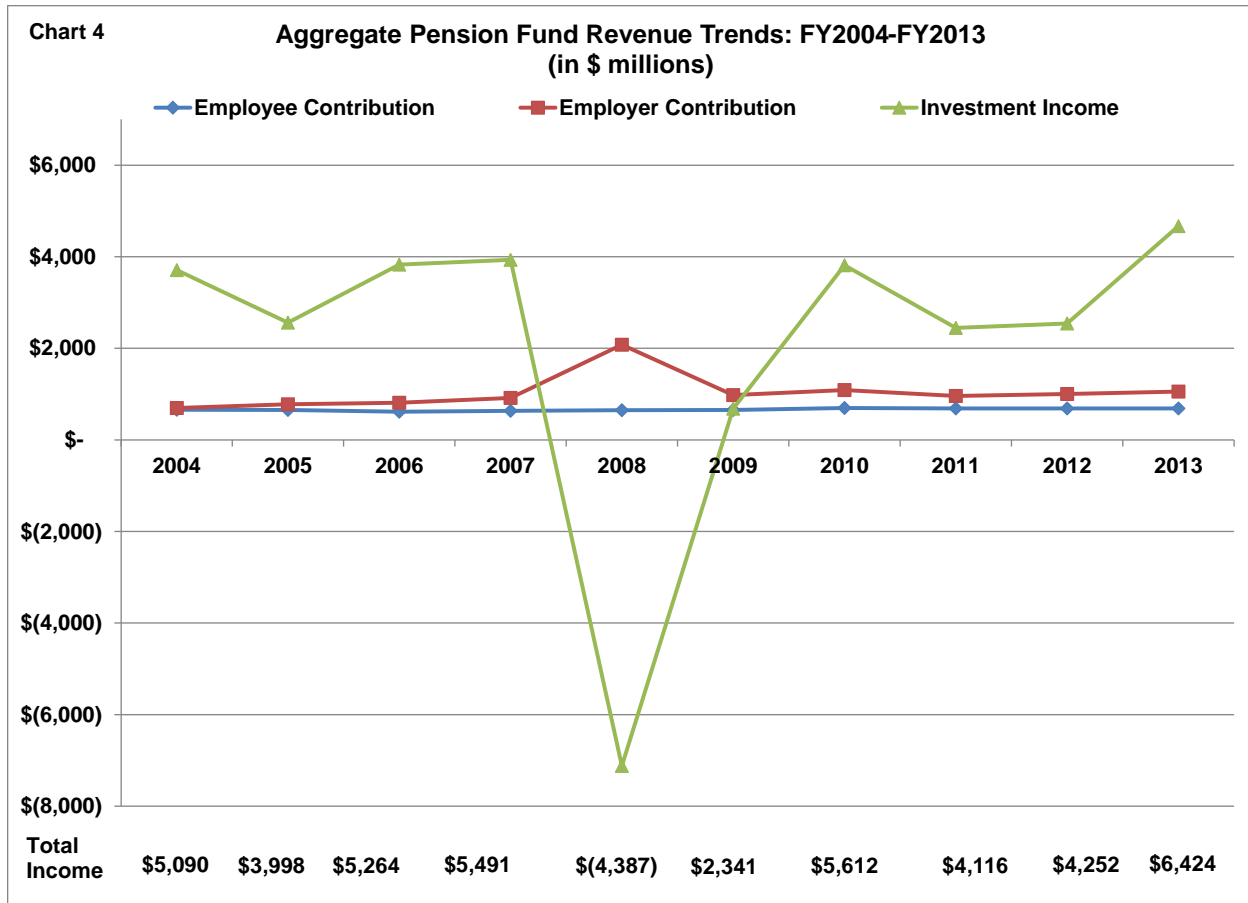
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<sup>26</sup> For example, if the size of the fund is four times greater than payroll, a 10% asset loss, paid on a level dollar (same dollar amount each year) basis over 30 years assuming a 7% rate of return, would add an additional contribution of 3.2% of payroll in the first year. If the fund was twice as large—or eight times greater than payroll—the same 10% loss would add an additional cost of 6.2% of payroll in the first year.

<sup>27</sup> Alicia Munnell, *State and Local Pensions: What Now?* 2012, p. 48.



The following chart illustrates the significant fluctuations in investment income for ten Chicago area pension funds FY2004-FY2013. Despite the fluctuations, the chart also illustrates how large a portion of revenue for public pensions comes from investment income, compared to the employee and employer contributions.<sup>28</sup>



### Employee Contributions

Employee contributions to pension funds are generally established as a percentage of salary. For most funds covered in this report, there are separate contribution rates for regular employee pensions, survivor benefits and automatic annual increases on annuities. All employee contributions are set in State statute.

As shown in the following chart, in FY2013 the total employee contribution for the funds examined in this report range from 8.0% to 11.5%. Employee contribution rates for the funds subject to recent reforms, including the MWRD, Chicago Park District and Chicago Municipal and Laborers' funds, will see increases in employee contributions over the next several years if the reforms are not overturned in the courts. Four of the five State funds, on the other hand, will

<sup>28</sup> The larger than average employer contribution in 2008 is due to an extraordinary contribution from a Chicago Transit Authority Pension Obligation Bond related to a 2008 pension reform package.

see a decrease in employee contributions if the state pension reform is upheld by the Illinois Supreme Court.

FY2013 Employee Contribution Rates (% of salary)	
Fund	Rate
SERS*	8.00%
SURS	8.00%
TRS	9.40%
Judges	11.00%
General Assembly	11.50%
Fire	9.125%
Police	9.00%
Municipal	8.50%
Laborers'	8.50%
MWRD	10.00%
Cook County**	8.50%
Forest Preserve	8.50%
CTA	10.125%
Chicago Teachers'	9.00%
Park District	9.00%

Note: Table does not include any extra amounts that may be contributed for death benefits. Some teachers and school district employees' contributions are "picked up" by their school district.  
 \* SERS employees covered by Social Security contribute 4.00%; SERS employees covered by the alternative formula contribute 12.5% if they do not have Social Security and 8.5% if they do.  
 \*\* Cook County Sheriff's employees contribute a total of 9%.

### Employer Contributions

As noted above, employer contributions are required to make up for any shortfalls in funding of a public pension. **While there is no single required standard for employer contributions to public sector plans, the contribution ideally should include funding for two types of obligations: their annual cost and any contribution needed to reduce unfunded liabilities.**

First is the annual cost of the pension plan's benefits, which is called the "normal cost." The second payment is to reduce and eventually pay off any obligations of the plan that are not covered by the fund's assets. This is called "amortizing the unfunded liability." Both kinds of contributions are calculated by an actuary using a complex set of calculations and demographic and economic assumptions about what might happen in the future.

Not all public employers in Illinois are required to contribute to their pension plans on the normal cost plus amortization basis. In fact, many have consistently underfunded such a standard for many years even though they were following State contribution law. Levels of employer contributions can have a significant impact on the funded status of a defined benefit plan. Specifically, stable but consistently inadequate contributions and so-called pension holidays are both very detrimental.

The many frameworks for employer contributions to public pension plans in Illinois are set in State statute. They vary considerably between plans, with some plans required to make contributions related to funding levels and other plans required to make contributions that are a fixed multiple of employee contributions. Fixed employer contributions can have the advantage

of helping a government budget and plan more easily. However, fixed contributions do not respond to risks such as investment losses that necessitate increased employer funding and have therefore tended to result in significant and ongoing underfunding.

It is important to note that the ultimate source of employer contributions to public employee pensions is from taxes paid by residents.

### ***State of Illinois Employer Funding***

As of the publication date of this primer, the five State pension funds remain on a 50-year funding plan passed by the Illinois General Assembly in 1994, which went into effect in 1995. Since then, the General Assembly approved (in 2013) a comprehensive pension reform package, Public Act 98-0599, that would have changed the State funding schedule for four out of five of the plans, but it has not yet been implemented pending resolution of litigation by the Illinois Supreme Court. See page 39 for more information about the State pension litigation.

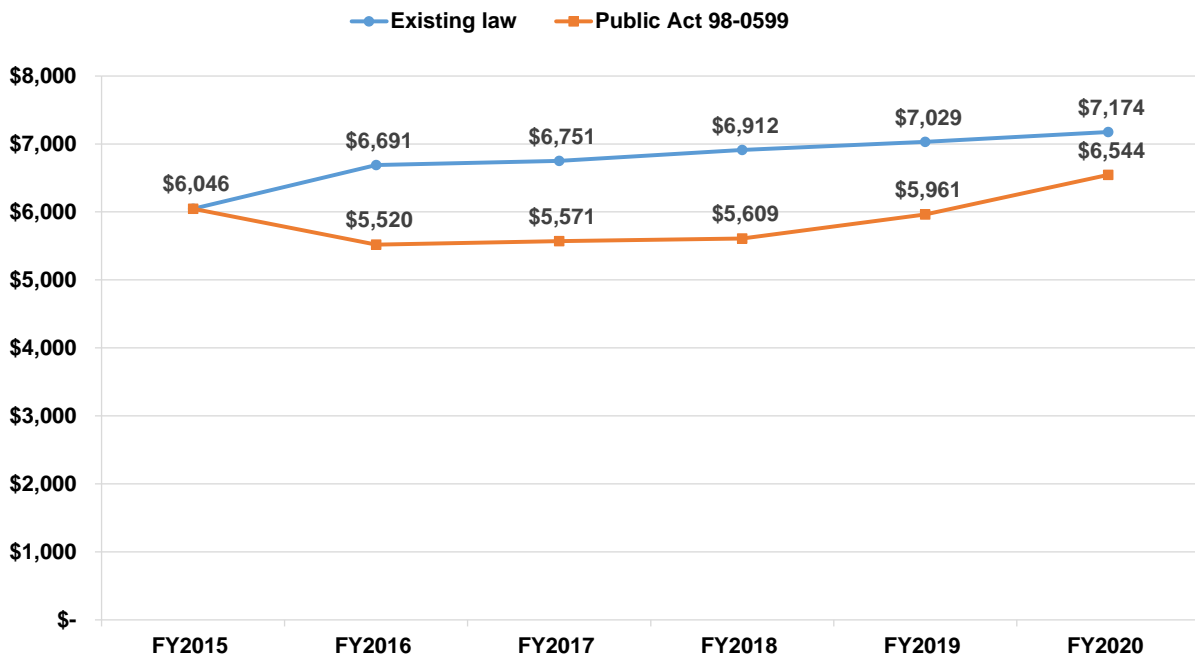
The 50-year plan was intended to increase employer funding gradually over many years with the result that all five State funds would have sufficient assets to cover 90% of their obligations by the year 2045. However, the plan started out with a “ramp” that allowed the State to contribute much less than the ideal standard, leading to an increase in the amount of pension obligations that were not covered by assets. The plan is also significantly **backloaded**, meaning that even after the end of the “ramp” it was still designed to have smaller contributions in the beginning and much higher contributions later. The result is that the unfunded obligations of the pension funds are projected to grow each year until approximately 2030, when the total state contributions will finally be large enough to reduce the unfunded obligations of the plan.

The new funding plan under Public Act 98-0599, also known as Senate Bill 1, would shorten the period to pay down the unfunded obligations of the plan to 30 years and has no “ramp.” Additionally, its funding goal is a more actuarially sound 100%, compared to the prior 90% goal. While the contributions under P.A. 98-0599 are also scheduled to increase over time they are not projected to rise to as large a number as the annual contributions under the 1995 law due to changes made to benefits. See page 36 of this report for more information about P.A. 98-0599.

The Civic Federation used the review done by the Illinois General Assembly’s Commission on Government Forecasting and Accountability (COGFA)’s actuary to compare required contributions under the new and old laws for FY2015-FY2020, updated for the actuarial valuation done as of June 30, 2014. This projection, shown in the next chart, assumes that the new law is implemented in FY2016 and shows a lower contribution under P.A. 98-0599 that is due to benefit reductions rather than underfunding.

Chart 1

**State of Illinois Projected Statutorily Required General Funds Pension Contributions: FY2015-FY2020 (in \$ millions)**



Sources: FY2013 and FY2014 State of Illinois Pension Fund Actuarial Valuations; Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial condition as of June 30, 2013*, March 2014, pp. 98 and 133-138; Commission on Government Forecasting and Accountability, *Segal Actuarial Cost Study on P.A. 98-0599 (SB1)*, March 26, 2014, Exhibits 4-6.

***Chicago Area Pension Funding***

The ten local pension funds in the Chicago area included in this report are funded in several different ways. The Chicago Teachers’ Fund and CTA Fund are both on 50-year schedules that are somewhat similar to the State’s funding schedule. As of FY2013, the other local funds’ employer contributions were calculated on the basis of a multiple of what employees contributed two years prior.

The CTA makes its employer contributions based on a percentage of payroll that varies depending on the financial need of the funds with a 90% funding goal by 2059. The CTA was put on this schedule by state law passed in 2008 in response to a significant funding crisis that projected the fund would run out of money by 2013.<sup>29</sup>

The Teachers’ Fund employer contribution is based on an actuarially-calculated amount that includes a small contribution provided by the State of Illinois. The funding plan was originally passed by the General Assembly in 1995 and the goal was 90% funding by 2045, like the State funding plan. However, the employer was not required to make a contribution as long as the fund was above 90% funded, or essentially from when the funding law went into place until the mid-2000s. The District was also granted a three-year partial pension funding holiday from FY2011-

<sup>29</sup> Civic Federation, *Status of Local Pension Funding Fiscal Year 2011*, p. 9.

FY2013 that reduced the employer contribution to approximately the normal cost and extended the date by which the Fund had to reach 90% funding to 2058.

The multiple-based contributions for the City of Chicago, Park District, MWRD and Cook County funds in FY2013 ranged from 1.0 to 2.26 times what employees contributed two years prior. It is important to note again here that the multiplier-based contributions do not automatically adjust to risk and therefore to meet the funding needs of the pensions. This means that the employers are not making contributions calculated by an actuary to be sufficient to pay the annual cost of the pensions and eventually pay down the unfunded obligations. While fixed contributions are helpful for budgeting and at one time these multiples may have been sufficient for the actuarial needs of the funds, for at least the last ten years they have fallen short. The consequence of underfunding is that both higher current and future taxpayer contributions will be needed and pension benefits will be reduced.

Pension reforms passed in 2010, 2012 and 2014 would move most of the local funds from the set multiplier basis to either an annually calculated actuarial amount or a contribution related to the pension system's funding needs, but still expressed as a multiple for budgeting reasons. It remains to be seen whether lawsuits will block the implementation of these changes. Only Cook County and the Forest Preserve District Funds have not yet had their employer contribution system changed in State law.

See the Civic Federation's *Status of Local Pensions* reports for more detailed descriptions of the employer pension contribution changes.

### **How Do We Know if an Employer is Contributing Enough Money?**

There is no required funding standard for public plans. However, until 2013 there was an accounting requirement to which their contributions could be compared. Governments used to be required by the Governmental Accounting Standards Board (GASB) to calculate an "annual required contribution (ARC)" for accounting reporting purposes.<sup>30</sup> The ARC equals the sum of the annual cost of the pensions (the normal cost described above) and an amount to reduce the unfunded liability. It was a reasonable, if not perfect, approximation of the amount of money the employer might contribute each year in order to cover costs attributable to the current year and to reduce unfunded liabilities. It was therefore a good benchmark to which to compare the level of employer contributions in order to evaluate whether a government was underfunding its pension obligations and can still be used to consider historical contribution trends.

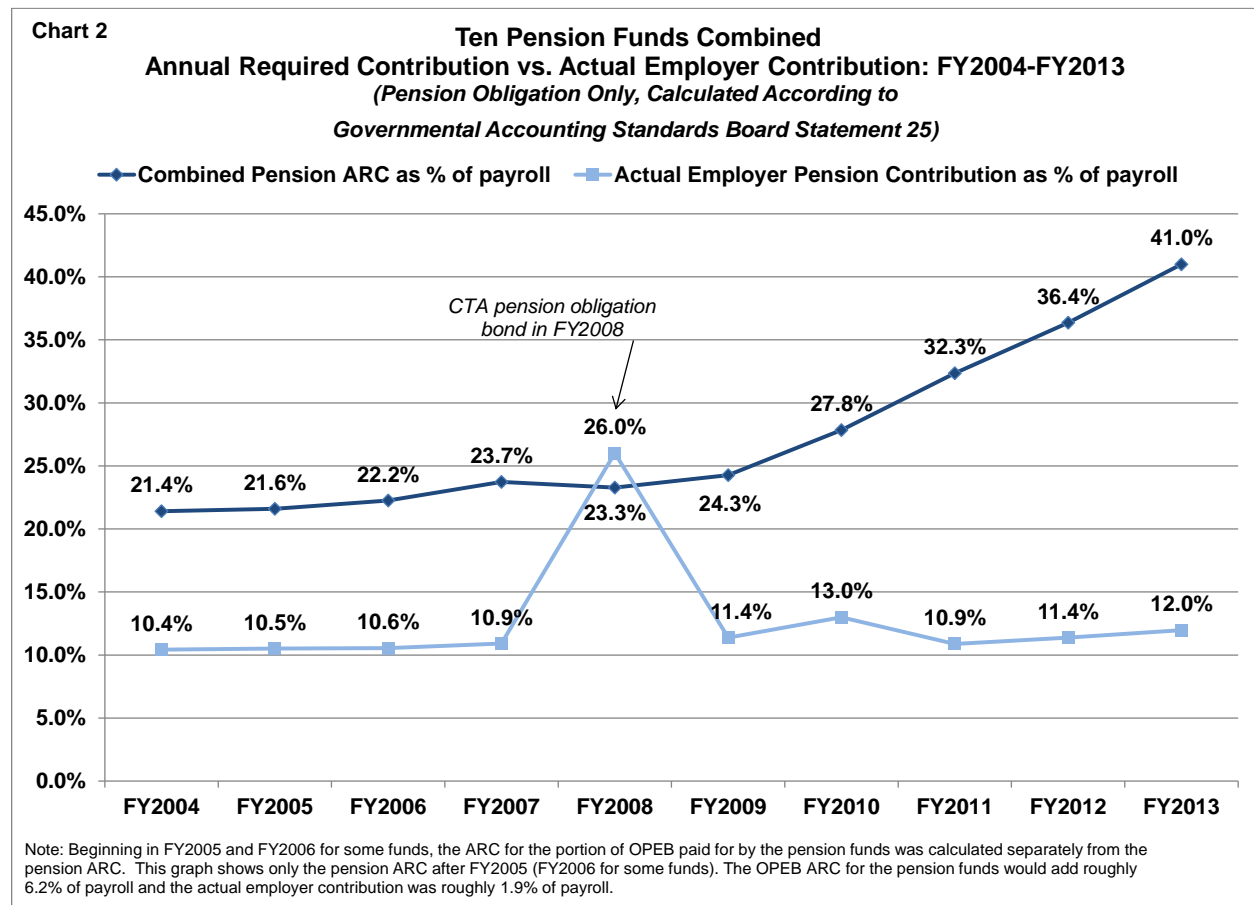
The following graph illustrates how far short of a reasonable funding standard 10 local pension Funds in the Chicago area have fallen over the past 10 years. It shows the gap between the aggregate amounts contributed by local government funds in the Chicago area and their combined pension ARC. Both are expressed as a percent of payroll from FY2004-FY2013.

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<sup>30</sup> GASB Statement Number 67 ended the ARC reporting requirement for FY2014.

Expressing a contribution as a percentage of payroll gives an idea of affordability. Too high or a growing contribution as a percentage of payroll indicates that the benefit may not be affordable.

The aggregate pension ARC has exceeded the aggregate employer contribution for nine of the last ten years, with the exception of FY2008 when the CTA pension fund received an exceptionally large contribution financed by pension obligation bonds required by its pension reform law. The spread between the two amounts has grown from an 11.0% of payroll gap in FY2004 to a 29.0% of payroll gap in FY2013. In other words, to fund the pension plans at a level that would both cover the normal cost and pay down the unfunded liabilities over 30 years, the employers would have needed to contribute an additional 29.0% of payroll, or \$2.2 billion, in FY2013.



As a result of underfunding built into the State of Illinois' 50-year funding plan, it has also fallen short compared to the ARC over at least the past ten years.

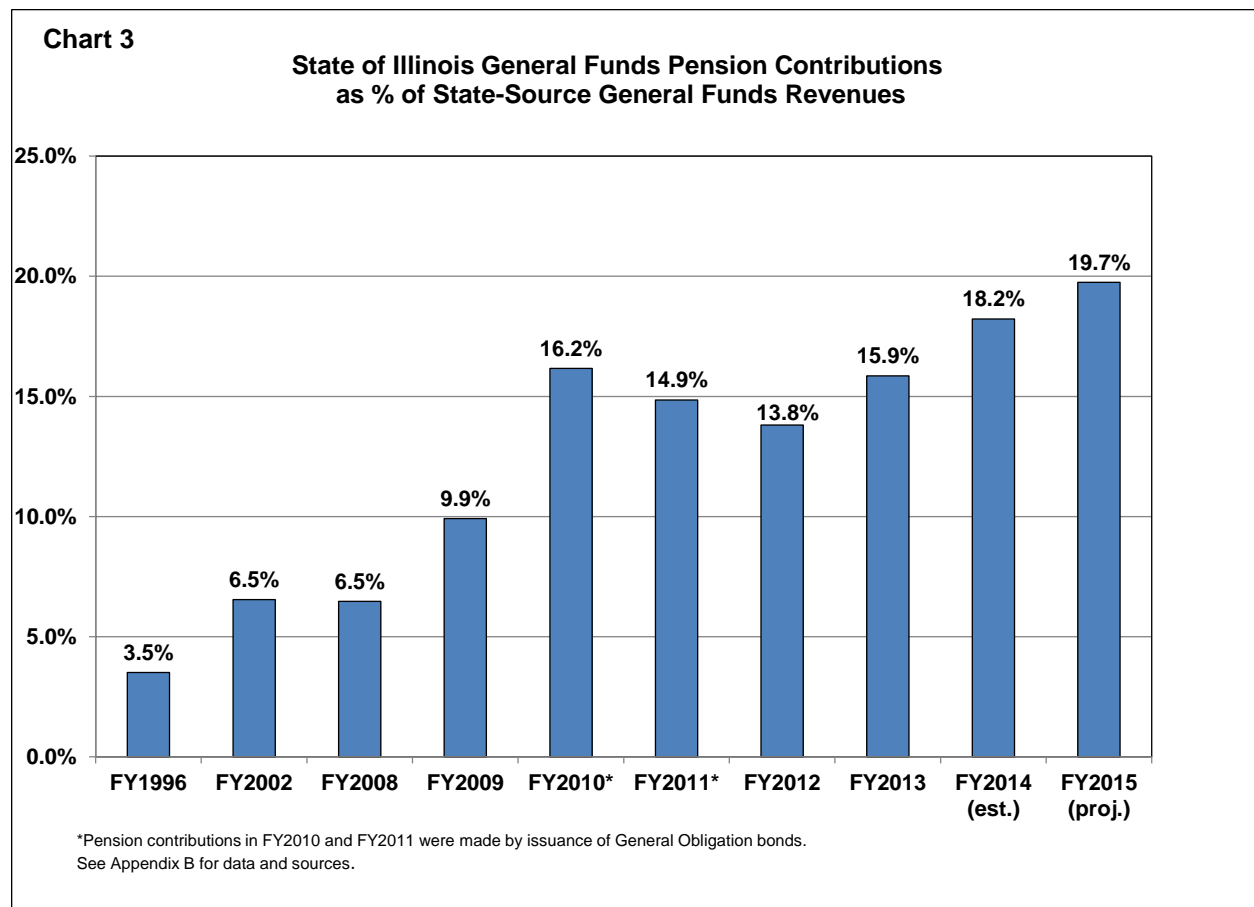
Unfortunately, in FY2014 and beyond there is not yet a generally accepted benchmark payment to which analysts can compare funding levels. While the GASB accounting cost was a convenient marker, each public plan must now develop its own funding standard. Several actuarial professional organizations have published guidelines. Within the public plan community, a common practice has yet to emerge. However, it is certain that all of the governments in this report have generally underfunded pensions compared to the objective

standard of the ARC. This underfunding, along with pension holidays for some of the plans, contributed significantly to their precarious funding status.

***How Have Pensions Impacted Government Budgets?***

One of the motivations behind the State’s pension reform initiatives is that growing pension contributions have adversely affected the State’s budget. The following chart shows what percentage of State-source operating revenues have been spent on General Funds pension contributions since FY1996, when the 50-year funding plan started.<sup>31</sup>

Under the funding plan, the State’s annual pension contributions grew from \$513 million, or 3.5% of State-Source revenues, in FY1996 to \$6.046 billion, or 19.7% of projected revenues, in FY2015. The decline in the share of resources consumed by pensions after FY2010 reflects the increase in income tax rates midway through FY2011. The percentage of the state’s budget dedicated to pension funds is only projected to grow in the future, with a maximum operating fund State contribution of \$14.6 billion in 2045 under current law.



As shown in Chart 2 on the previous page, the local governments that use a fixed multiple of employee contributions have generally seen their contributions remain level, no matter how

<sup>31</sup> The State’s General Fund is its operating budget.

much funding levels have fallen. While budget stability might be helpful for the government in the short-term, it means that the pension funds unfunded obligations have been growing because the contributions have not been sufficient for the needs of the fund and that current and past taxpayers have paid less than their fair share at the cost of future taxpayers. However, the funds whose contributions are related to the plan's funding needs consuming a greater share of available revenues due to making up for past underfunding and investment losses. For example, CPS will make a contribution to its pensions of \$675 million in FY2016, which is 28% relative to projected payroll and 28% compared to the projected property tax levy, the District's main source of revenue.

## **HOW DO WE MEASURE PUBLIC PENSION FUND FINANCIAL HEALTH?**

In addition to evaluating whether employers are contributing enough to the pension fund through a comparison to the ARC, it is important to understand how well-funded a pension plan is and whether funding is improving or declining over time.

### **Measures of Pension Fund Status**

Pension fund status indicators show how well a pension fund is meeting its goal of accruing sufficient assets to cover its liabilities. Ideally, a pension fund should hold exactly enough assets to cover all of its actuarial accrued liabilities.

The term **actuarial accrued liability** or AAL refers to future obligations to current retirees, as well as obligations for benefits earned to date by current employees. A pension fund is considered 100% funded when its assets equal the actuarial accrued liabilities. A funding level under 100% means that a fund's current assets are less than the amount needed to meet its accrued liabilities.

Assets and liabilities are calculated using a number of assumptions. Liabilities are calculated using assumptions about such factors as future salary increases, retirement age and life expectancy. Assets can be reported by their **market value**, which is how much the fund's investments are worth as of a certain date. This measure can be subject to significant market volatility, depending on the amount of riskiness in investments.

Assets of public pension plans are sometimes valued based on their **smoothed market value**, which lessens the effects of short-term market volatility by recognizing each year's investment gains or losses over a period of three to five years. For example, one smoothing technique recognizes 20% of the difference between the expected (based on the assumed rate of return) and actual investment returns for each of the previous five years. This means that if a fund's investment return was \$100 million under expectations in one year, under asset smoothing, it would not immediately recognize that \$100 million loss. Instead the fund would recognize \$20 million in the first year, \$20 million in the second, etc. until after five years, the entire \$100 million loss was accounted for in the fund's measurement of its assets.

As of FY2014, pursuant to Governmental Accounting Standards Board Statement No. 67, all funds must report their assets for accounting purposes based on the market value.



It is important to consider two critical factors when evaluating the status of pension funds. First, **the status of a pension fund is strongly affected by the actuarial methods and assumptions made.** Changes to assumptions and methods can produce substantially different pictures of a fund's status.

Second, because pension financing is long-term in nature, **pension fund status is best understood through multi-year trends, rather than looking at a single year by itself.** Negative multi-year trends are cause for concern and indicate a need for a change in funding strategy or benefit levels. A given indicator that is low, but has been stable for several years, may be less worrying than a once-healthy fund that has experienced a steep decline in recent years.

The two pension fund status indicators used in this report and described below are funded ratio and unfunded liabilities.

### ***Funded Ratio***

The most basic indicator of pension fund status is its ratio of assets to liabilities, or “funded ratio.” In other words, this indicator shows how many pennies of assets a fund has per dollar of liabilities. For example, if a plan had \$100 million in liabilities and \$90 million in assets, it would have a 90% funded ratio and about 90 cents in assets per dollar of obligations to its employees and retirees.

When a pension fund has enough assets to cover all its accrued liabilities, it is considered 100% funded. **This does not mean that further contributions are no longer required.** Instead it means that the plan is funded at the appropriate level as of a certain date. A funding level under 100% means that a fund does not have sufficient assets on the date of valuation to cover its actuarial accrued liability.

The best situation for any pension fund is to be fully funded, with 100% of accrued liabilities covered by assets because it means that the plan is doing a good job of maintaining intergenerational equity with current taxpayers appropriately paying for the cost of current public employees' benefits. There is no *official* industry standard or best practice for an acceptable funded ratio other than 100%.<sup>32</sup> Private sector pension plans that are less than 100% funded must amortize, or pay off, their unfunded liability over seven years. Private sector pension plans that are less than 80% funded are considered “at-risk,” and must make additional contributions to boost their funded ratio.<sup>33</sup>

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<sup>32</sup> American Academy of Actuaries, “Issue Brief: The 80% Pension Funding Standard Myth,” July 2012. [http://actuary.org/files/80%25\\_Funding\\_IB\\_FINAL071912.pdf](http://actuary.org/files/80%25_Funding_IB_FINAL071912.pdf)

<sup>33</sup> See the Pension Protection Act of 2006, Public Law 109-280, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109\\_cong\\_public\\_laws&docid=f:publ280.109.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_public_laws&docid=f:publ280.109.pdf). See also Deloitte, “Securing Retirement: An Overview of the Pension Protection Act of 2006,” (August 3, 2006). [http://www.hreonline.com/pdfs/01012007Extra\\_Pension\\_SecuringRetirement.pdf](http://www.hreonline.com/pdfs/01012007Extra_Pension_SecuringRetirement.pdf). The Worker, Retiree, and Employer Recovery Act signed into law by President Bush on December 23, 2008 loosened some of these requirements by, for example, extending from 10 to 13 the number of years an “endangered” (less than 80% funded) plan is given to implement an improvement strategy. See the Worker, Retiree, and Employer Recovery Act of 2008, HR 7327, Public Law 110-458, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_cong\\_bills&docid=f:h7327enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h7327enr.txt.pdf).

Some observers claim that there is no real need for governments to achieve 100% funding. They argue that governments, unlike private corporations, are not at risk of dissolving and therefore can meet their obligations in perpetuity. However, from an intergenerational equity perspective, undercharging current taxpayers only means a need for higher taxes later. If a plan is underfunded, it should have a plan to attain 100% funding in a reasonable period of time to improve intergenerational equity going forward.

The Illinois General Assembly had previously set 90% as a target funded ratio for state pension funds, stating, “90% is now the generally-recognized norm throughout the nation for public employee retirement systems that are considered to be financially secure and funded in an appropriate and responsible manner” (40 ILCS 5/1-103.3). More recent reforms of the Chicago Municipal and Laborers’ Funds, the Chicago Park District Fund and the MWRD Fund also use a 90% rather than a 100% standard. However, the comprehensive pension reform package for four of the five State pension funds, Public Act 98-0599, enacted in December 2013, uses a 100% funding standard.<sup>34</sup> See page 33 to read more about these reform initiatives.

### ***Unfunded Actuarial Accrued Liabilities***

Unfunded actuarial accrued liabilities (UAAL) are obligations not covered by assets. Unfunded liability is calculated by subtracting the value of assets from the actuarial accrued liability of a fund. For example, if a plan had \$90 million in assets and \$100 million in liabilities, its unfunded liability would be \$10 million.

One of the purposes of examining the unfunded liability is to measure a fund’s ability to bring assets in line with liabilities. Healthy funds are able to reduce their unfunded liabilities over time. On the other hand, substantial and sustained increases in unfunded liabilities are a cause for concern.

Since unfunded liability numbers among public pension funds in Illinois tend to be very large, it can be useful to put them in context by dividing them by population. This measurement demonstrates the relative size of the unfunded liability and is called the per capita unfunded liability.

One of the functions of measuring unfunded liability in comparison to a government’s population is to measure a fund’s ability to manage or make progress in reducing its unfunded liability. It also shows the financial burden on residents who ultimately must pay for shortfalls through taxes. A gradual decrease in the unfunded liability per capita over time would indicate that a reasonable funding strategy is being pursued. If the unfunded liability continues to increase per resident, then a new funding strategy and a reduction in the level of benefits granted by the fund may need to be considered.

### **What Makes the Funded Ratio and Unfunded Liabilities Change?**

The following are four major factors that influence a pension plan’s funding status.

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<sup>34</sup> For more on P.A. 98-0599, see below and <http://www.civicfed.org/iifs/blog/actuarial-reports-show-illinois-savings-pension-reform-law>.

### ***Sustained Investment Losses or Gains***

When rates of return are positive, investment income usually represents the majority of a fund's total income. Employee and employer contribution amounts are relatively stable from year to year but investment income can fluctuate widely. Multi-year investment gains or losses that differ significantly from the assumed rate of return have a major impact on fund assets.

### ***Employer and Employee Contributions***

Changes in employer or employee contributions can have a significant impact on the funded status of a defined benefit plan.

Chronic shortfalls in employer contributions are a very serious drag on the health of many pension funds. For the State of Illinois, since 1996, insufficient employer contributions allowed under law have contributed \$36.0 billion to the growth in the unfunded liability of \$82.0 billion.<sup>35</sup>

Temporary reductions in employer contributions, sometimes referred to as "pension holidays," can also have a significant negative effect on the fiscal health of a pension fund. The State of Illinois, Chicago Public Schools and Chicago Park District have all used "pension holidays" to help balance their budgets at the cost of their pension contribution.

Failure to provide sufficient employer funding today effectively pushes the costs of today's government services onto tomorrow's taxpayers. Employer funding of public pension plans should be sufficient to keep the promises made to today's employees for their future retirement in order to ensure intergenerational equity for taxpayers.

### ***Benefit Enhancements***

Enhancements to retirement benefits can take various forms, such as an increase in any portion of the annuity formula, reduction in total years of service required for maximum annuity or a reduction in retirement age for maximum annuity. Specific early retirement initiatives designed to encourage older employees to retire early can also be considered benefit enhancements, although they are typically available only for a limited time and sometimes require additional employer or employee contributions.

Benefit enhancements increase the promised payments that will be made to beneficiaries either in the form of pension annuities or other post retirement benefits such as retiree healthcare and therefore increase a pension fund's liabilities. Sometimes those enhancements are granted in exchange for short-term employee concessions on salaries or health insurance.

Offering benefit enhancements may be an attractive option to employers, since achieving immediate short-term savings on other employee costs often appears to be a more pressing need than controlling longer-term pension liabilities. If overly generous and especially if they are unfunded, however, they can contribute to significant long-term cost increases. It is also

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<sup>35</sup> Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems: Financial Condition as of June 30, 2013*. March 2014, p. 31.

important to note that benefit enhancements, once enacted, are protected by the Illinois Constitution's pension clause. Because they cannot easily be changed, public pension benefit enhancements are particularly risky in Illinois.

Benefit enhancements are part of the overall economic package offered by employers to employees and may be negotiated either inside the scope of collective bargaining or outside of it. For all of the funds analyzed in this report, plan changes that may or may not have been negotiated by labor and management must also be passed by the Illinois General Assembly and codified in state statute.<sup>36</sup> Labor and management are also free to lobby the General Assembly for changes independently.

### *Changes to Actuarial Assumptions and Methods*

Actuarial assumptions and methods can change for various reasons, including demographic trends, analysis of recent plan experiences or new industry standards such as GASB requirements. It is considered standard practice for actuaries to review and reassess assumptions, such as mortality rates and expected salary increase rates, every five years. There are a number of acceptable methods for computing a plan's assets, liabilities and funding requirements. It is important to recognize that a change from one method to another can produce a significant change in a fund's assets, liabilities or funding requirements.

One of the most important assumptions and one that has one of the largest impacts on the calculation of a pension fund's liabilities is the **assumed rate of return on investment**. All of the State of Illinois' three largest pension funds and nearly all of the local funds in this report have reduced their assumed rate of return on investment at least once in the last few years.<sup>37</sup>

The assumed rate of return on investment, also called the discount rate, is used to calculate the present value of the future obligations of the systems. This is the amount that needs to be invested as of a specific date to provide benefit payments as they come due. Reducing the rate increases the present value of future commitments because investments are not assumed to make as much money. This results in higher liabilities and lower funded ratios.

### **WHAT IS THE STATUS OF STATE AND LOCAL PENSION FUNDS?**

This section examines ten year trends for funded ratio and unfunded liability for the five state and ten local funds. The analysis uses smoothed or "actuarial" asset values for both measures because those are the most commonly cited measures.<sup>38</sup> As noted above, smoothed values mitigate market volatility by recognizing extraordinary investment gains and losses over several years.

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<sup>36</sup> For the CTA, pension plan changes were made exclusively through the collective bargaining process until the passage of Public Act 95-0708 that codified CTA pension benefits in state statute.

<sup>37</sup> See the Civic Federation and Institute for Illinois' Fiscal Sustainability blogs for extensive coverage of this issue. <http://www.civicfed.org/blog> and <http://www.civicfed.org/iifs/blog>.

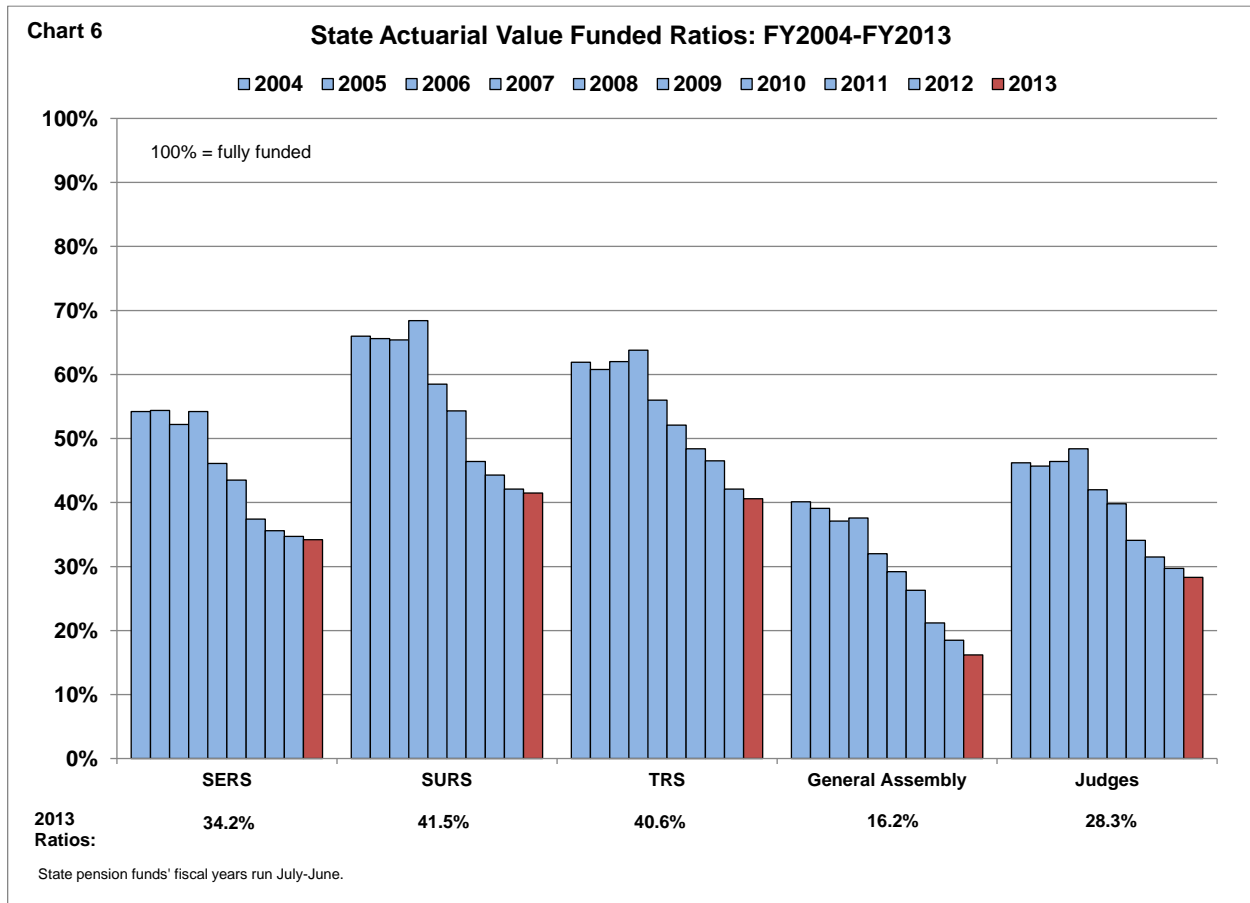
<sup>38</sup> The CTA fund uses market value as its actuarial value starting in FY2011. The five State of Illinois funds changed to asset smoothing in FY2009.

## Funded Ratios for State and Local Pension Funds

It is important to consider actuarial funded ratios over time. The following charts show changes in funded ratios to both state and local funds over a ten-year period.

### State Funds

The following chart illustrates the five State pension funds' funded ratios since FY2004. The significant and ongoing decline in funded ratio is a serious cause for concern and was a significant indicator that the State's existing funding and benefit structure needed adjustment.

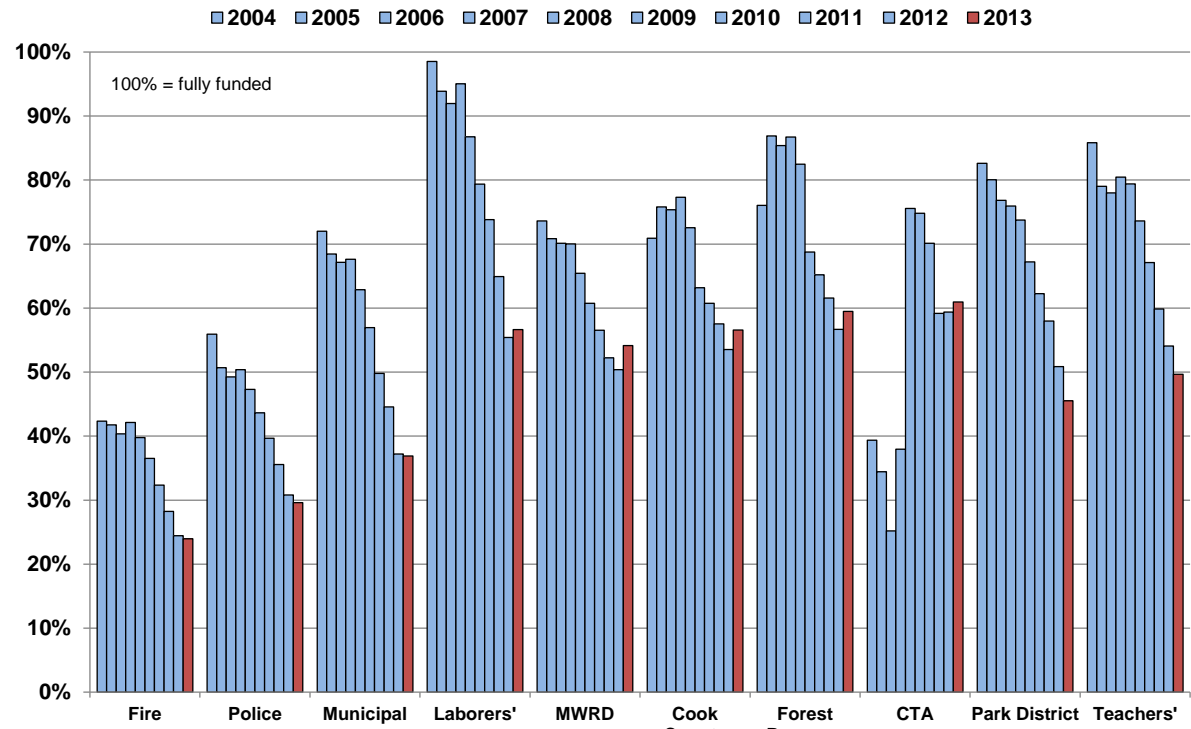


### Large Local Funds in the Chicago Area

The following chart illustrates the ten local government pension funds' funded ratios since FY2004. The steep decline in funded ratio is also a very serious cause for concern. While funded ratios for several funds recovered somewhat in FY2013 due to extraordinary investment returns, it is simply not possible for the mature funds in this report, especially funds in such fiscal distress, to invest their way out of their crisis.

Chart 7

Actuarial Value Funded Ratios: FY2004-FY2013



2013 Ratios: 24.0% 29.6% 36.9% 56.7% 54.1% 56.6% 59.5% 60.9% 45.5% 49.7%

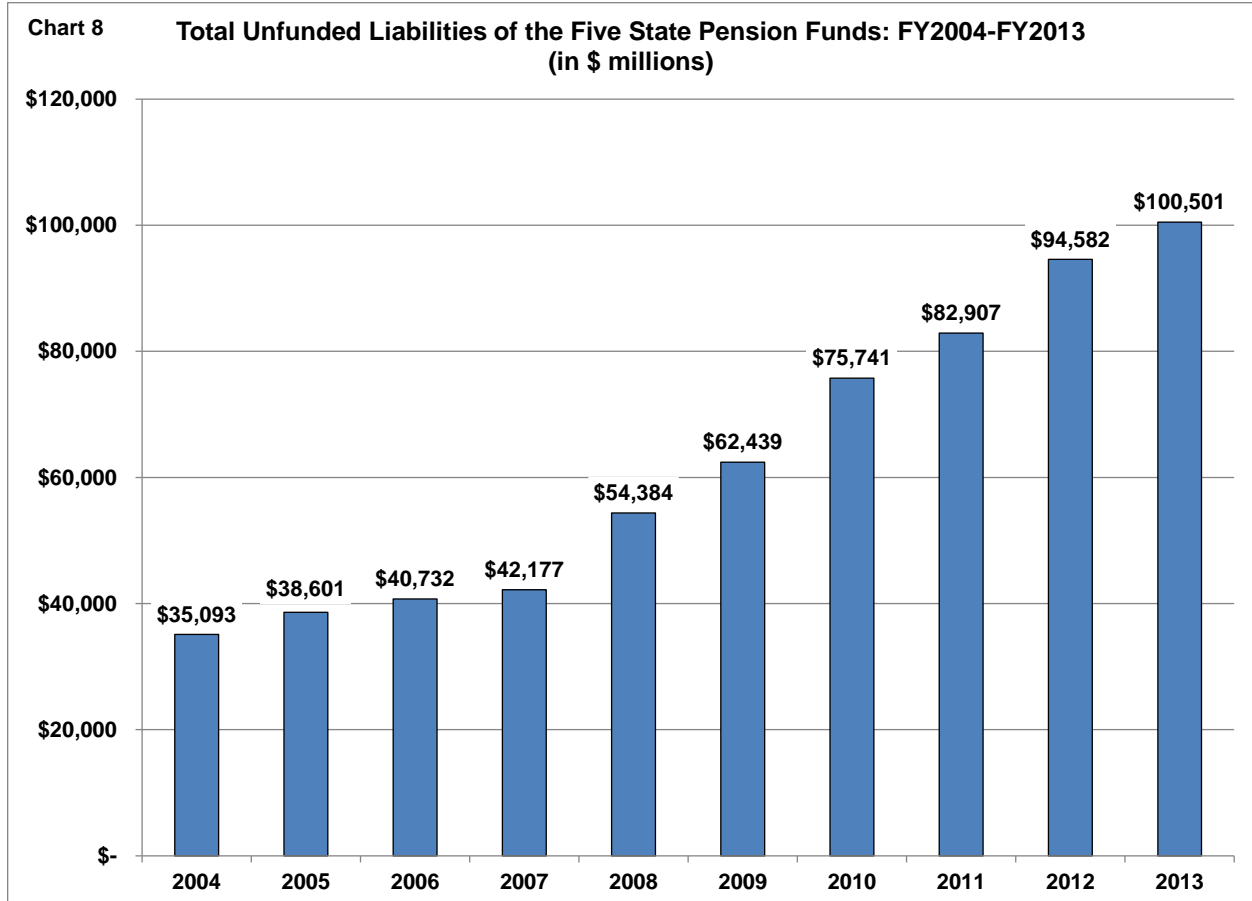
Calendar Year Funds: Fire, Police, Municipal, Laborers', MWRD, Cook County, Forest Preserve, CTA, Park District (FY2013 and after)  
 July 1 to June 30 Funds: Teachers', Park District (until FY2012)

**Unfunded Liability for State and Local Funds**

The difference between assets and actuarial accrued liabilities is known as the unfunded liability. The unfunded actuarial accrued liability (UAAL) is calculated by subtracting the actuarial value of the assets from the actuarial accrued liability of each fund. Put more simply, the unfunded liability is the amount by which the funds are short of assets to cover their obligations.

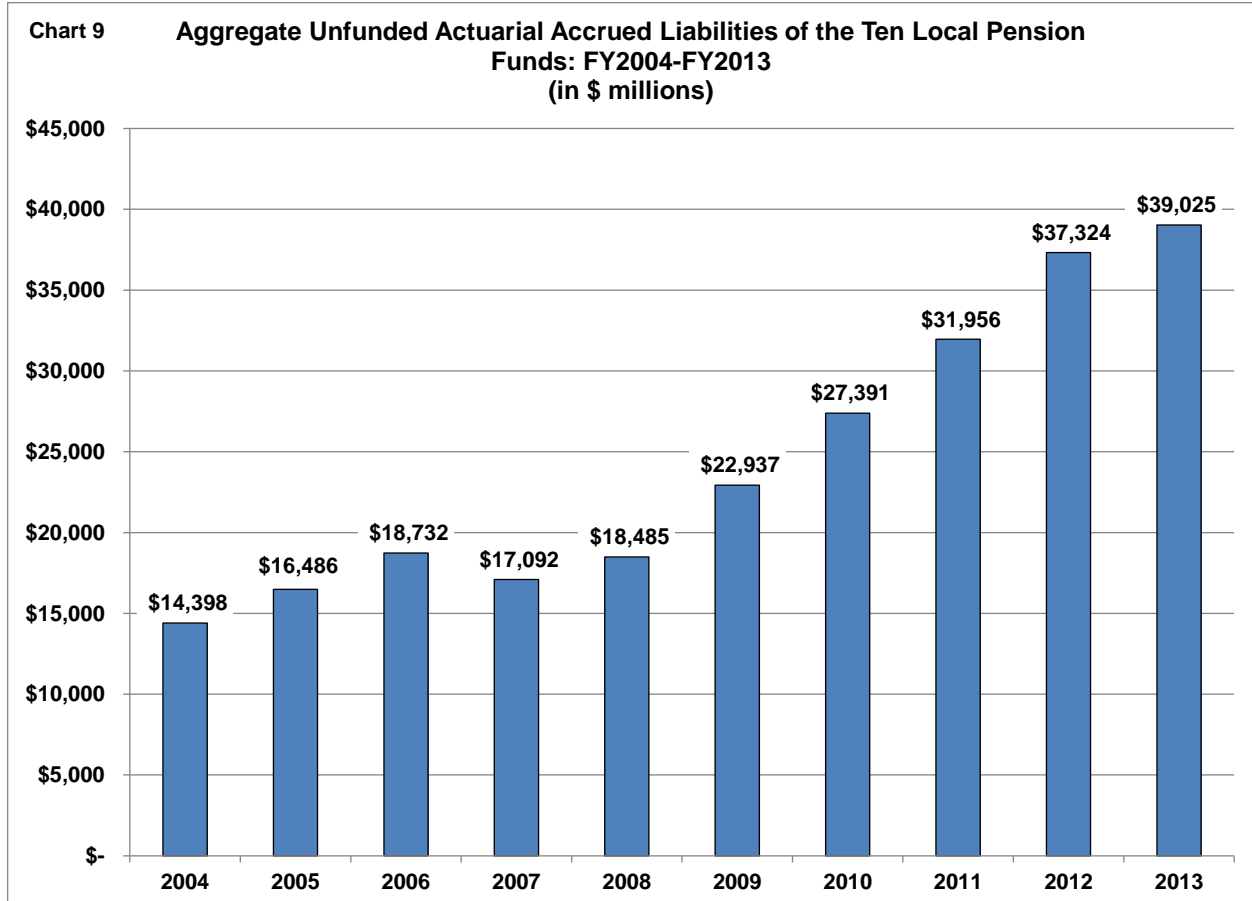
### State Funds

The aggregate unfunded liability of the five State pension funds has increased rapidly in recent years, as shown in the following chart. Between FY2004 and FY2013 the unfunded liability increased by \$65.4 billion or 186.4%.



### *Large Local Funds in the Chicago Area*

The aggregate unfunded liability of the ten local Chicago area pension funds has also increased rapidly in recent years, as shown in the following chart. Between FY2004 and FY2013, the aggregate unfunded liabilities for all ten funds increased by \$24.6 billion or 171.0%.

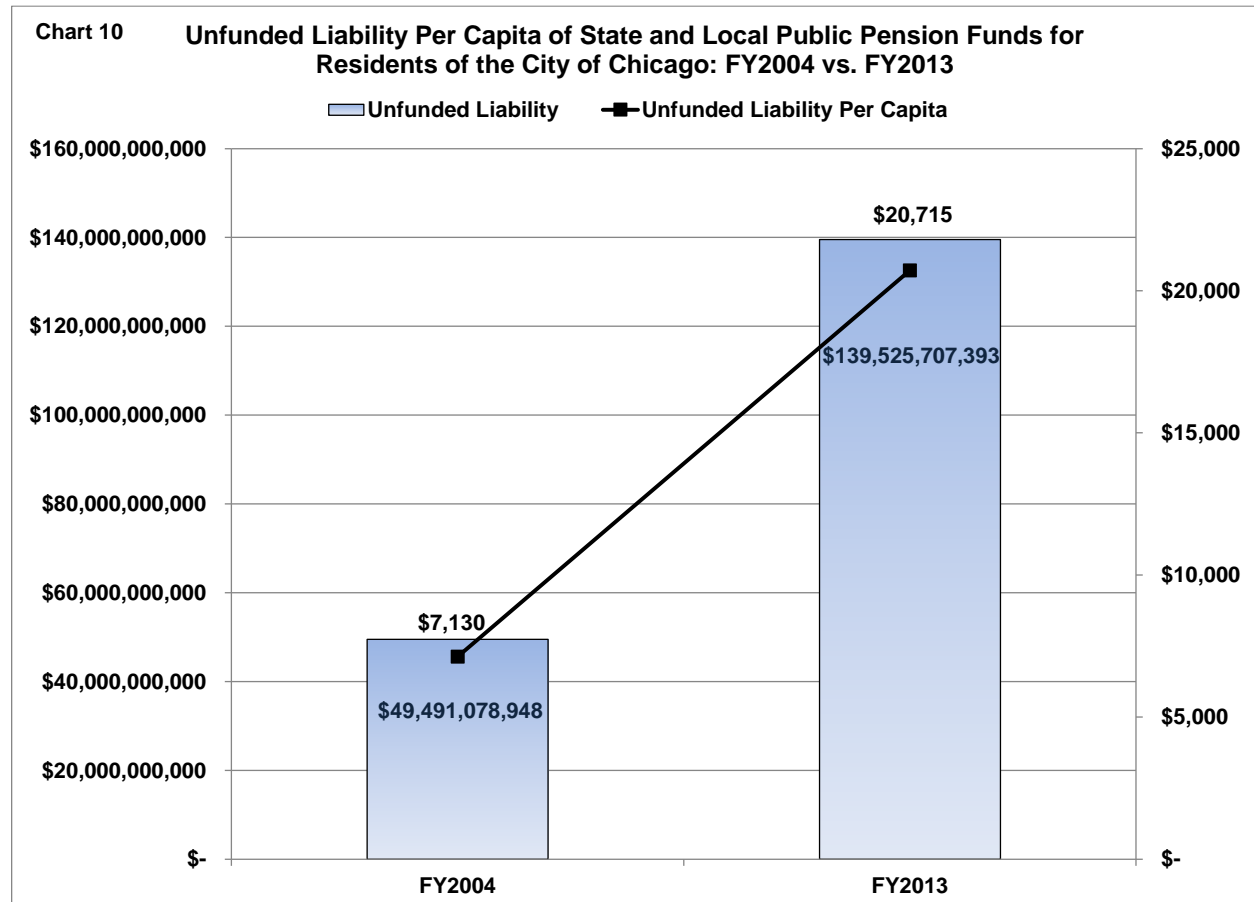


### *Per Capita Trends for State and Local Funds*

Calculating the unfunded liability per capita offers a sense of scale for unfunded liabilities. The following graph shows that the unfunded liabilities per capita for all ten local pension funds and the five State-sponsored pension funds for which Chicago residents also pay taxes was \$7,130 per resident of Chicago in FY2004, growing to \$20,715 by FY2013.



The following graph also illustrates the \$90.0 billion increase in the local and State funds' total unfunded liabilities between FY2004 and FY2013.



Together, the funded ratio and unfunded liability measures for all of the funds in this report point to unsustainable benefit levels given their fiscal condition and insufficient employer contributions. As described in the next section, over the last five years, there has been ongoing discussion of the State's pension crises and some movement toward benefit and contribution reform.

### **WHAT WERE THE MAJOR PENSION BENEFIT REFORM EFFORTS IN ILLINOIS 2010-2014?**

There have been several major efforts to reform pension benefits in Illinois since 2010.<sup>39</sup> The following sections briefly describe their provisions. In making changes to pension benefits, first for new employees and then for some current employees and retirees, the State of Illinois was part of a nationwide trend in reducing pension benefits. According to the National Council of State Legislators, since 2009, more than 45 states have made significant changes to their

<sup>39</sup> The Chicago Transit Authority pension benefit and funding reforms passed in 2008 were also a landmark. See Civic Federation, *Status of Local Pensions FY2011*, for more information. The MWRD reforms of 2012, while also important, only impacted employer and employee contributions and are not described here. See this blog post for more details: <http://www.civicfed.org/civic-federation/blog/mwr-retirement-fund>.

retirement plans, including increasing employee contributions, reducing benefits, or both.<sup>40</sup> See also the following section on the State's constitutional protection of public pension benefits for information on legal theories affecting the State's ability to alter current or future pension benefits.

### **2010: Reforms for New Employees**

In 2010 the Illinois General Assembly and then-Governor Pat Quinn made the first effort toward rectifying both the state's worst-in-the-nation pension crisis and assisting local pension funds in distress. In April and December 2010, legislation was enacted that created a two-tier benefit system with lower benefits for State and many local government employees hired on or after January 1, 2011. Over time, the reduced benefits were intended to slow the growth in unfunded liabilities as new employees were hired and fewer members remain in the old benefit tier.

**Public Act 96-0889** created a new tier of benefits for public employees who become members of many public pension plans on or after January 1, 2011.<sup>41</sup> (The so-called Tier 2 employees.) The Act affects new members of the following funds analyzed in this report: TRS, SURS, SERS, General Assembly, Judges', Municipal, Laborers', Cook County, Forest Preserve, MWRD, Teachers' and Park District Funds. CTA employees were not included because their fund was reformed in 2008 when it was just a few years from insolvency.

In general, the major benefit changes are an increase in full retirement age from 60 to 67 and early retirement age from 55 to 62, reduction of final average salary from the highest 4 year average to the highest 8 year average, a \$106,800 cap on pensionable earnings, and the reduction of the automatic cost of living adjustment from 3% compounded to the lesser of 3% or one half of the increase in Consumer Price Index not compounded. However, Public Act 96-0889 did not guarantee the future solvency of the affected funds. Additionally, according to the Teachers' Retirement System, Tier 2 employees pay more than the full cost of their benefits, effectively subsidizing the State by helping to pay down the unfunded liability. Tier 2 TRS members contribute 9.4% of their salary for pensions (the same as members prior to 1/1/2011 aka Tier 1 members), but the pension benefit is worth 7%.<sup>42</sup>

The legislation did not change employer or employee contributions, with the significant exception of a partial employer contribution holiday that was granted to the Chicago Public Schools.

**Public Act 96-1495** created a new tier of benefits for public employees who become members of many public safety pension funds on or after January 1, 2011. The Act affects new members of the following funds analyzed in this report: Chicago Police and Chicago Fire. In general, the major benefit changes are an increase in full retirement age from 50 to 55, reduction of final average salary from the highest 4 year average to the highest 8 year average, a \$106,800 cap on pensionable earnings and change in the automatic cost of living adjustment from 1.5% not

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<sup>40</sup> NCSL cited in NASRA, "Effects of Pension Plan Changes on Retirement Security," April 2014, p. 1.

<sup>41</sup> A "trailer bill" to correct technical problems with Public Act 96-0889 was enacted in December 2010 as Public Act 96-1490.

<sup>42</sup> Teachers' Retirement System, "Topics & Report," Winter 2015. <http://trs.illinois.gov/pubs/topics/winter15.pdf>.

compounded to the lesser of 3% or one half of the increase in Consumer Price Index not compounded.

The public safety pension legislation also changed employer contributions. The change for the City of Chicago is significant. The City's contribution is currently a fixed multiple of the employee contributions made two years prior. As noted above, these multiples have provided much less than is needed to adequately fund the plans for at least the last ten years (see page 20).

Public Act 96-1495 will require the City to begin making contributions in 2015 sufficient to bring the funded ratio of the Police Fund and the Fire Fund to 90% by the end of 2040. If the City fails to make its required contributions, the Illinois Comptroller will withhold State fund transfers to the City. Prior to the enactment of Public Act 96-1495, the Fire Fund was projected to run out of assets during 2021 and the Police Fund was projected to run out of assets during 2025.<sup>43</sup>

### **2013: Chicago Park District Reform Package**

Public Act 98-0622, passed November 7, 2013 and signed into law on January 7, 2014, makes changes to pension benefit levels for current retirees and employee members of the Chicago Park District pension fund. The provisions went into effect January 1, 2015. As of publication of this primer, no litigation has been filed challenging the law.<sup>44</sup>

Prior to the passage of P.A. 98-0622, the Park District Fund was projected to run out of funding in 2023; the reforms contained in the legislation are intended to make the fund more sustainable over the long term.<sup>45</sup> There are different changes to benefit levels for Tier I employees, Tier II employees and current retirees. The benefit change for current retirees is to reduce the current 3% simple interest automatic annual increase to the lesser of ½ of the increase in CPI-U or 3% simple. Additionally, all current retirees will see a suspension of the automatic annual increase in the years 2015, 2017 and 2019. Current employees will see a similar reduction to their automatic annuity increases when they retire, but will also make increased contributions to their pensions and will need to wait until they reach 58 years of age to access early retirement instead of 50 years of age.

Employer contributions will increase on a phased-in basis with a goal of 90% funded. The reforms are projected to raise the Park District's pension funding levels to 90% by 2049 and 100% by 2054. While most of the provisions of the reform did not go into effect until January 1, 2015, the reform package already had a major impact on the funded status of the Park District

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<sup>43</sup> Illinois Commission on Government Forecasting and Accountability, *Illinois Public Retirement Systems: A Report on the Financial Condition of the Chicago, Cook County and Illinois Municipal Retirement Fund Systems of Illinois*, November 2010, pp. 46, 108.

<sup>44</sup> An SEIU Local 73 newsletter dated May 2014 stated that their legal counsel has recommended the union wait to learn the decision on the constitutionality of Public Act 98-0599, the state pension reform package, which would show the legal precedent for all subsequent pension reform cases. <http://seiu73.org/files/2014/05/CPD-Newsletter-4-14.pdf>. According to the SEIU website, the union supported the reforms to current employee benefits, but not the changes to current retirees' benefits, which it views as unconstitutional.

<sup>45</sup> Park Employees' Annuity and Benefit Fund of Chicago, "Summary of New Pension Law - Public Act 98-0622," January 31, 2014. [http://www.chicagoparkpension.org/Summary\\_of\\_New\\_Pension\\_Law\\_-\\_Public\\_Act\\_98-0622.pdf](http://www.chicagoparkpension.org/Summary_of_New_Pension_Law_-_Public_Act_98-0622.pdf)

Fund, reducing the fund's unfunded liability by \$109.4 million or 18.5% and increasing the funded ratio by five percentage points to 45.5% in the fund's FY2013 financial statements.

### **2013: State of Illinois**

Public Act 98-0599, passed on December 3, 2013 and signed into law on December 5, 2013, makes changes to pension benefit levels for current retirees and Tier 1 employee members of SERS, SURS, TRS and the General Assembly Retirement System but not the Judges' Retirement System. It also required the State to pay off its unfunded pension obligations more quickly and completely than the previous plan.<sup>46</sup> The provisions were scheduled to take effect on June 1, 2014, but its implementation was delayed by legal challenges and the case is currently before the Illinois Supreme Court.

Due largely to decades of inadequate State contributions, Illinois has the most underfunded retirement systems of any state.<sup>47</sup> The State's total unfunded pension liability stood at \$104.6 billion on June 30, 2014, based on the market value of assets, and pension assets covered only 42.9% of pension liability. The changes to benefit levels mainly focus on changes to the automatic annual annuity increase for both retirees and Tier 1 employees, changing from a 3% compounded benefit to one tied to years of service and is based on simple interest. There are also set years in which retirees will not receive an increase to their annuity. Current employees also see a phased-in increase to the retirement age, a cap on pensionable salary and a *decrease* to employee contributions of one percentage point.

The new law represents the State's first actuarially sound pension funding plan, designed to result in 100% funding over 30 years and was expected immediately to reduce the unfunded liability by \$21.1 billion and lower State contributions by \$137.4 billion over 30 years and by \$1.2 billion in FY2016, according to a report by the legislature's Commission on Government Forecasting and Accountability.<sup>48</sup> Five lawsuits have been filed by current State employees and retirees, alleging that the law violates the pension protection clause of the Illinois Constitution. As noted above, these consolidated lawsuits are currently being considered by the Illinois Supreme Court and are reviewed in the next chapter of this primer.

### **2014: City of Chicago**

Public Act 98-0641, passed April 8, 2014 and signed into law on June 9, 2014, makes changes to pension benefit levels for current retirees and employee members of two of the City of Chicago's four pension funds, the Municipal and Laborers' Funds. Its provisions went into effect January 1, 2015, but its constitutionality is being challenged in Cook County Circuit Court.

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<sup>46</sup> Public Act 98-0599, enacted on December 5, 2013. A summary of the law's provisions can be found on the website of the Teachers' Retirement System at <http://trs.illinois.gov/press/reform.htm#sb1> (last visited on March 12, 2015).

<sup>47</sup> Pew Center on the States, *The Widening Gap Update*, June 2012, p. 5.

<sup>48</sup> Commission on Government Forecasting and Accountability, *Segal Actuarial Cost Study of P.A. 98-0599 (SB1)*, March 26, 2014, p. 1. Due to changes to investment return assumptions by the State of Illinois' three largest retirement funds and other factors, these numbers are expected to change.

The Municipal Fund was projected to run out of money within 10 to 15 years and the Laborers' Fund in 15 to 20 years if P.A. 98-0641 had not passed the General Assembly. The major provisions of the law include increases to the employer contribution and employee contribution and changes to the automatic annual increase for current retirees and Tier I employees. The automatic annual increase is reduced for current retirees and for Tier I employees from the current 3% compounded to the lesser of 3% or half of the increase in CPI-U, simple interest and there will be years in which retirees will not receive an annual increase. Employer contributions change from the current actuarially insufficient multiple of prior employee contributions and increase on a five-year ramp until the City is annually contributing an amount that will increase funding to 90% by the end of 2055. If the City fails to make the required contributions, the Illinois Comptroller will withhold State fund transfers to the City. This provision is similar to the "intercept" described above for the Police and Fire Funds that was enacted as part of Public Act 96-1495. The increase in contributions for FY2015 (payable in FY2016) is projected to be approximately \$89 million.<sup>49</sup>

In December 2014, two lawsuits were filed in Cook County Circuit Court that challenge the constitutionality of pension reforms for the Chicago Municipal and Laborers' funds. The plaintiffs were also seeking an injunction on the implementation of the provisions of the law that went into effect on January 1, 2015. However, after the Illinois Supreme Court announced it would hear oral arguments on the State pension litigation on March 11, 2014, the plaintiffs in the Chicago cases asked for their suits to be stayed pending the Supreme Court's decision.<sup>50</sup>

## **WHAT ARE THE RESTRICTIONS ON CHANGING PENSION BENEFITS IN ILLINOIS?**

The legal protection available to public employee retirement benefits depends on state law. In the early twentieth century, state courts considered pensions to be gratuities from the government that could be changed or repealed at any time. This legal approach changed over time in most states to provide more protection to employees. Most pension benefits are now covered by contract or property rights theories that generally protect previously accrued benefits.<sup>51</sup>

Illinois is considered to have among the most stringent pension protections. It is one of a handful of states, including New York and Arizona, with specific constitutional provisions barring benefit reductions.

The Illinois Constitution of 1970 (Article XIII, Section 5) states: "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Legal opinions have varied on the interpretation of this provision and whether it is absolute in its prohibition of changes to benefits.<sup>52</sup>

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<sup>49</sup> City of Chicago, *Annual Financial Analysis 2014*, p. 89.

<sup>50</sup> Karen Pierog, "Chicago pension reform lawsuits put on hold," Reuters, February 23, 2015.

<sup>51</sup> Monahan, Amy, *Public Pension Plan Reform: The Legal Framework* (March 17, 2010), Education, Finance & Policy, Vol. 5, 2010; Minnesota Legal Studies Research No. 10-13. Available at SSRN: <http://ssrn.com/abstract=1573864>

<sup>52</sup> See for example legal briefs submitted to the Illinois Supreme Court by the Illinois Attorney General and by the Plaintiffs in the ongoing Illinois pension litigation. See also amicus briefs submitted by various groups. All briefs

The public pension clause cannot apply to the benefits of employees not yet hired and who do not therefore have a contract, which is why the 2010 pension reforms focused on the benefits of future employees. However, as General Assembly members considered the recent reforms described above that apply to current employees and retirees, they deliberated over several legal options. One possibility was for each employee to voluntarily agree to plan changes. A version of this approach was supported by Senate President John Cullerton, who has maintained that reducing pension benefits would be constitutional only if employees and retirees were given something of value in exchange.<sup>53</sup>

Illinois Governor Bruce Rauner has proposed another option, which would freeze benefits under Tier 1 for current employees and transfer them to Tier 2, which has a lower level of benefits, for the rest of their time in state government. Because the benefits employees accrued up to the point at which the freeze would go into effect would not change, the Governor argues that this plan would not diminish or impair accrued benefits and would therefore be constitutional.<sup>54</sup>

Public Act 98-0599 includes a modest reduction in employee contributions that was intended to offset other benefit changes, but the exchange argument was not the General Assembly's main argument for the law's constitutionality. Instead, the law relies mainly on a legal argument relating to the State's police power, its inherent ability to take action necessary to preserve public security, order, health, morality and justice in extraordinary circumstances.<sup>55</sup> However, the changes must meet the legal standard of being reasonable and necessary to serve an important public purpose. The Illinois Attorney General makes this argument in her brief to the Illinois Supreme Court on the pension reform law.

Other observers have argued that the pension reform law does not impair benefits because pension benefits were already impaired by the fact that they were extremely underfunded. Thus, the pension law could be argued to improve, rather than impair benefits because it will improve the funded level and thus the likelihood that members will receive full benefits. This is the argument that attorneys for the City of Chicago make in its defense of the 2014 pension reforms for the Municipal and Laborers' funds.

Opponents, including labor unions, employees and retirees, contend that the law violates the plain language interpretation of the State's constitutional pension protections by reducing pension benefits. Attorneys for the plaintiffs make this argument in their brief to the Illinois Supreme Court.

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available on the Illinois Supreme Court website at

<http://www.state.il.us/court/SupremeCourt/SpecialMatters/2014/default.asp>.

<sup>53</sup> See the Civic Federation's Institute for Illinois' Fiscal Sustainability blog for more:

<http://www.civicfed.org/iifs/blog/union-backed-pension-reform-proposal-approved-senate>.

<sup>54</sup> See the Civic Federation's Institute for Illinois' Fiscal Sustainability blog for more:

<http://www.civicfed.org/iifs/blog/illinois-governor-proposes-%E2%80%99hard-freeze%E2%80%99-pension-benefits>.

<sup>55</sup> To read more about the police power argument, visit

[http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=4616](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4616).

The Illinois Supreme Court's ruling on whether P.A. 98-0599 passes constitutional muster by any argument is expected in 2015.

### **Recent Court Cases and Decisions Involving the Illinois Pension Clause**

As of the publication date of this report, there have been recent decisions by the Sangamon County Circuit Court and the Illinois Supreme Court that involved the Illinois Pension clause.

#### ***Kanerva v. Weems***

In July 2014 the Illinois Supreme Court ruled that a State law passed in 2012 that required State retirees to make contributions toward their healthcare was unconstitutional. Before the 2012 changes, the State paid the entire bill for health insurance premiums for those who retired prior to 1998. For those who retired beginning in 1998, the State contributed 5% of the premium cost for each full year of service, up to a maximum of 100% for retirees with 20 or more years of service. Approximately 91% of the more than 81,900 retirees covered by the State's group insurance program did not pay any health insurance premiums as of January 2011.<sup>56</sup>

The Illinois Supreme Court held that State subsidies for retiree health insurance premiums are a pension benefit covered by the pension protection clause of the Illinois Constitution. The case was sent back to Sangamon County Court, which had previously dismissed it on the grounds that healthcare benefits were not covered by the pension provision. The case remains at the Circuit Court as of publication of this primer.

While the Supreme Court's ruling in *Kanerva* does not consider the same arguments that are being made by the State in defense of Public Act 98-0599, some observers believe the Court's ruling may suggest that the Supreme Court might take an expansive view of the pension protection clause in that case.

#### ***Consolidated Litigation on Public Act 98-0599***

Five separate lawsuits were filed in opposition to Public Act 98-0599 soon after it was signed into law. These cases were later consolidated into one case that was tried in Sangamon County Court.

#### **Ruling by Sangamon County Court**

On May 14, 2014 Sangamon County Judge John Belz ordered that implementation of P.A. 98-0599, which had been scheduled for June 1, 2014, be delayed pending further action on the legal issues.<sup>57</sup> After the Supreme Court ruled on *Kanerva*, Judge Belz said that the ruling would play a role in his decision, which could come before the end of 2014.<sup>58</sup>

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<sup>56</sup> Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2.

<sup>57</sup> Bernard Schoenburg, "Judge blocks pension changes until ruling on lawsuit," *State Journal-Register*, May 14, 2014.

<sup>58</sup> Doug Finke, "Judge: Insurance ruling will factor into pension reform decision," *State Journal-Register*, September 4, 2014.

On November 21, 2014, one day after hearing oral arguments in the case, Judge Belz issued the Circuit Court of Sangamon County's decision on the case. He ruled that the changes to the benefits provided by the State retirement systems to current and future retirees violated the pension protection clause of the Illinois Constitution. Judge Belz rejected the argument that the State has special sovereign police powers of the State to reduce benefits of retirees due to a fiscal emergency. The denial was not based on the argument for the powers presented by the Attorney General, but rather a lack of judicial precedent to support the claim that they exist.

#### Appeal to Illinois Supreme Court

After the Sangamon County Court's ruling, the Illinois Attorney General immediately appealed the decision to the Illinois Supreme Court. The Attorney General also applied for accelerated consideration of the case. The Court granted the motion and oral arguments were held on March 11, 2015.

#### ***Litigation on Chicago Municipal and Laborers' Reforms***

In December 2014, litigation was filed in the Cook County Circuit Court seeking to have Public Act 98-0641, pension reform for the Chicago Municipal and Laborers' funds, overturned on the basis that the changes were unconstitutional. The plaintiffs' motion for an injunction on the implementation of the provisions of the reforms was put on hold pending a ruling from the Illinois Supreme Court on the State pension reform law.

#### **WHAT ARE THE CIVIC FEDERATION'S PENSION REFORM RECOMMENDATIONS?**

Although the Illinois General Assembly has passed and Governors have now enacted several pieces of legislation intended to improve the sustainability of State and some local pension funds, there are still many funds that remain in crisis.

The Civic Federation's recommendations to improve the sustainability of pension funds across Illinois ultimately depend on the Illinois Supreme Court's decision on the constitutionality of previously passed reforms. We continue to advocate for additional reforms, increased transparency and improved governance that will ensure adequate, sustainable benefits for employees and retirees at a cost that is affordable to taxpayers.

#### **Pass Comprehensive Reform Package for Cook County and the Forest Preserve District of Cook County Pension Funds**

At the end of the 2014 spring legislative session, a comprehensive pension reform package for Cook County and the Forest Preserve District of Cook County was introduced in the General Assembly. The County had been working with labor representatives to develop a plan with a somewhat different approach to reform than that pursued in Public Act 98-0599, the Chicago Park District or the Chicago Municipal and Laborers' reforms.

The bill would reduce some pension benefits for current employees and increase employer and employee contributions to the funds. The agreed reform package chooses to retain retirees' compounded 3% automatic annual increases and a compounded increase for employees hired



before January 1, 2011. However, it also includes more stringent benefit reductions that compensate for the expense of the compounded increase, including changes to how final average salary is calculated, a reduction to the retirement benefit calculation and downside triggers that suspend all annual pension increases if funding gets too low. The package of reforms is projected to increase funding levels to 100% within 30 years.

The reforms passed the Illinois Senate but had stalled in the House when the session ended in May 2014 and were not considered during the veto session in late fall 2014. The Civic Federation believes it is important to get as many different approaches to reform before the Supreme Court as possible in order to understand what is allowed under the pension clause and what is not. Therefore, the Federation urges the General Assembly to re-introduce the legislation and pass it during the 2015 legislative session.

### **Pass Comprehensive Reforms to Benefits and Funding for Chicago, Suburban and Downstate Public Safety Pension Funds**

As discussed above, pension reforms were passed in 2010 that impact the funding of Chicago's Police and Fire funds. Under the law, in 2015, the City of Chicago is required to increase its contribution significantly in order to start a funding plan to achieve 90% funding by 2040. There were no reductions to benefits for current employees or retirees included in that legislation. The City projects that it will be required to contribute \$550 million more to its public safety funds under the legislation. Funding requirements were also changed for the 660 suburban and downstate public safety pension funds. For all public safety funds a provision was put in place to enforce the new funding requirements that will intercept State funding in increasing increments if governments do not make their full required contributions under the law.

The City of Chicago had indicated that it cannot afford the increased payment required under the 2010 law and other municipalities have also expressed concerns about how the expense of their funds has impacted their ability to deliver services. A coalition of towns and municipal groups, along with many mayors, including Chicago Mayor Rahm Emanuel, the Metropolitan Mayors Caucus and the Illinois Municipal League have jointly called for reform of Chicago, suburban and downstate police and fire funds. No comprehensive package of reforms has yet passed the General Assembly.

### **Civic Federation Pension Principles**

The following are the principles the Civic Federation believes should inform future pension reform initiatives in Illinois.

#### ***Benefit and Contribution Reforms***

##### Reduce Benefits for Current Employees and Retirees to More Sustainable Levels

Local governments will continue to have difficulty funding the pension promises they have made to their employees unless they move to reduce pension benefits for current employees and retirees in future pension reform legislation. The Civic Federation encourages the General

Assembly, Governor and local government officials to work together to pass legislation that will ensure that pension benefits are financially sustainable for workers, retirees and taxpayers.

#### Require Employer and Employee Contributions to Relate to Funding Levels

The Civic Federation recommends that employer and employee contributions for all funds be tied to actuarial liabilities and funded ratios, such that contributions are at levels consistent with the actuarial needs of the fund.

The Civic Federation believes that employees need to share in the rising costs of public pension plans and recommends that employer contributions and employee contributions be restructured such that employees pay a proportion of the annual required contribution. A proportional relationship should be set whereby, for example, the employer pays 50% and the employees pay 50% of the annual required contribution. Whatever the proportion, it is critical that both parties pay a share of required contributions, and that those contributions relate to the fiscal health of the fund.

#### Make Local School Districts, Universities and Community Colleges Responsible for Both Pension Funding and Benefit Decisions

In Illinois, state university and community college employees' pension benefits and pension benefits for teachers in school districts outside of Chicago are funded primarily by the State of Illinois. The Civic Federation supports the State of Illinois developing a reasonable plan for transitioning the normal cost of the pensions for these local employees to their actual employers. The Federation agrees that the responsibility for contributing to a worker's pension should rest with the employer who determines the worker's salary. However, any proposal must provide an adequate transition period to allow local school districts, universities and community colleges to handle the additional costs and should include a provision for how the State and local districts will distribute funding for current and future unfunded pension liabilities. In order to ensure that unwanted pension benefit enhancements are not granted by the State after the local employer takes control of funding the normal cost of their employees' pensions, the Civic Federation additionally recommends that the General Assembly grant local school districts, universities and community colleges the authority to determine benefit levels for their employees, instead of the State of Illinois determining benefits.

### ***Governance Reforms***

#### Consolidate Local Pension Funds

The Civic Federation recommends that the General Assembly consolidate local pension funds. There are over 660 local pension funds in the state, each with its own governing board, most of which are police and fire funds for individual municipalities. While these funds may enjoy local control over investing and disability decisions, we believe that the overall investment performance and administrative efficiency generated by economies of scale would greatly improve if funds were consolidated into the Illinois Municipal Retirement Fund (IMRF) or into an entity similar to the IMRF.

## Reform Pension Boards of Trustees to Balance Stakeholder Interests and Safeguard Assets

The mission of a public pension fund board of trustees should be to ensure effective benefit administration and safeguard the fund's assets through prudent investment oversight. Unfortunately, many pension boards also act as advocates on behalf of fund members, lobbying for benefit enhancements that ultimately increase the funds' liabilities.

As outlined in the Civic Federation's *Recommendations to Reform Pension Boards of Trustees Composition in Illinois* in 2006, the membership of most Illinois public pension boards does not reflect a balance of interests. We urge the General Assembly to undertake state and local pension governance reform that will:

- Balance employee and management representation so that employees and retirees do not hold the majority of seats;
- Develop a tripartite structure that includes independent citizen representation on pension boards; and
- Include financial experts on pension boards and require financial training for non-experts.

## **Reporting Reforms**

Civic Federation President Laurence Msall served on the Society of Actuaries' Blue Ribbon Panel on Public Pension Plan Funding. The Civic Federation strongly supports the reporting recommendations made in the Blue Ribbon Panel's final report.<sup>59</sup>

### ***Society of Actuaries Blue Ribbon Panel Reporting Recommendations***

The panel's report included recommendations that were designed to improve stakeholders' understanding of the financial condition and level of risk taken by public pension plans. These recommended disclosures include measures of:

- Plan maturity, such as the ratio of active employees to retirees and the ratio of the market value of assets to payroll. This information would help stakeholders understand the changing funding and investment needs of the fund as it matures.
- Plan cost, such as the ratio of the annual required contribution (ARC) to payroll and to the funding entities' total budget. This information would help stakeholders understand whether an actuarially-calculated measure of necessary funding is affordable to taxpayers.
- Payment experience, the ratio of contributions paid to the recommended contribution. This is a measure of whether a government is meeting the actual funding needs of the plan or whether they are pushing contributions into the future, which affects intergenerational equity.
- Investment risk, such as the plan liability at a risk-free rate. Such measures would help demonstrate how dependent the plan is on returns from risky investment and what the cost of the plan would be if those returns are not achieved.

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<sup>59</sup> Society of Actuaries, *Report of the Blue Ribbon Panel on Public Pension Plan Funding*, February 2014. Available at <https://www.soa.org/Files/Newsroom/brp-report.pdf>.

- Stress tests, consisting of projections of contributions and funded status under periods of higher or lower investment return, and in which recommended contributions were not fully paid. Such information helps stakeholders understand that evaluations of a fund's financial status are heavily dependent on the assumptions made and what happens when those assumptions are not achieved.