



**THE STATE OF ILLINOIS RETIREMENT  
SYSTEMS:  
Funding History and Reform Proposals**

**A Civic Federation Issue Brief**

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October 26, 2006**

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## OVERVIEW

This report provides a review of the status of the five retirement systems of the State of Illinois. It includes discussions of:

- the State’s historic underfunding of its pension funds;
- efforts to improve the funding situation, such as the 1995 funding reform law, the State’s 2003 issuance of \$10 billion in pension obligation bonds, and pension reforms proposed by Governor Blagojevich’s Blue Ribbon Pension Commission and other recent reforms proposed by the Blagojevich administration;
- the current funded status of the retirement systems; and
- pension funding reform recommendations from the Civic Federation

The State of Illinois funds five retirement systems for employees and retirees: the State Employees Retirement System (SERS), the Teachers’ Retirement System (TRS), the State Universities Retirement System (SURS), the Judges’ Retirement System (JRS), and the General Assembly Retirement System (GRS). In FY2007, the State reported that a total of 666,952 individuals are currently enrolled in these five systems.

<b>MEMBERS OF ILLINOIS RETIREMENT SYSTEMS</b>			
<b>Pension Fund</b>	<b>Members</b>	<b>Annuitants</b>	<b>Total</b>
Teachers	245,925	82,491	328,416
University	149,951	39,800	189,751
State Employees	91,423	54,828	146,251
Judges	962	900	1,862
General Assembly	275	397	672
<b>Total</b>	<b>488,536</b>	<b>178,416</b>	<b>666,952</b>

Source: FY2007 Illinois State Budget, p. 4-1.

Public employee pension benefits cannot be diminished for current employees. Article XIII, Section 5 of the Illinois State Constitution states that:

“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.”

No such guarantee is provided for other post employment benefits provided to retirees, such as health insurance.

### **THE PROBLEM: HISTORIC UNDERFUNDING OF THE STATE PENSION FUNDS**

The State of Illinois retirement systems historically have suffered from underfunding. This has ensured that Illinois consistently reports one of the lowest funded ratios among the fifty states.

According to a 2006 Standards & Poor's report, Illinois ranked 47<sup>th</sup> in the nation with respect to its retirement systems' funded ratios, just ahead of Rhode Island, Oklahoma, and West Virginia.<sup>1</sup>

<b>Funded Ratio</b>		
<b>Actuarial Value of Assets</b>		
Rank	State	Ratio
46	Connecticut	59.9%
47	<b>ILLINOIS</b>	<b>59.9%</b>
48	Rhode Island	59.4%
49	Oklahoma	57.0%
50	West Virginia	43.9%
<b>Mean (of 50 States)</b>		<b>83.5%</b>
<b>Median (of 50 States)</b>		<b>85.4%</b>

Source: Standard & Poor's

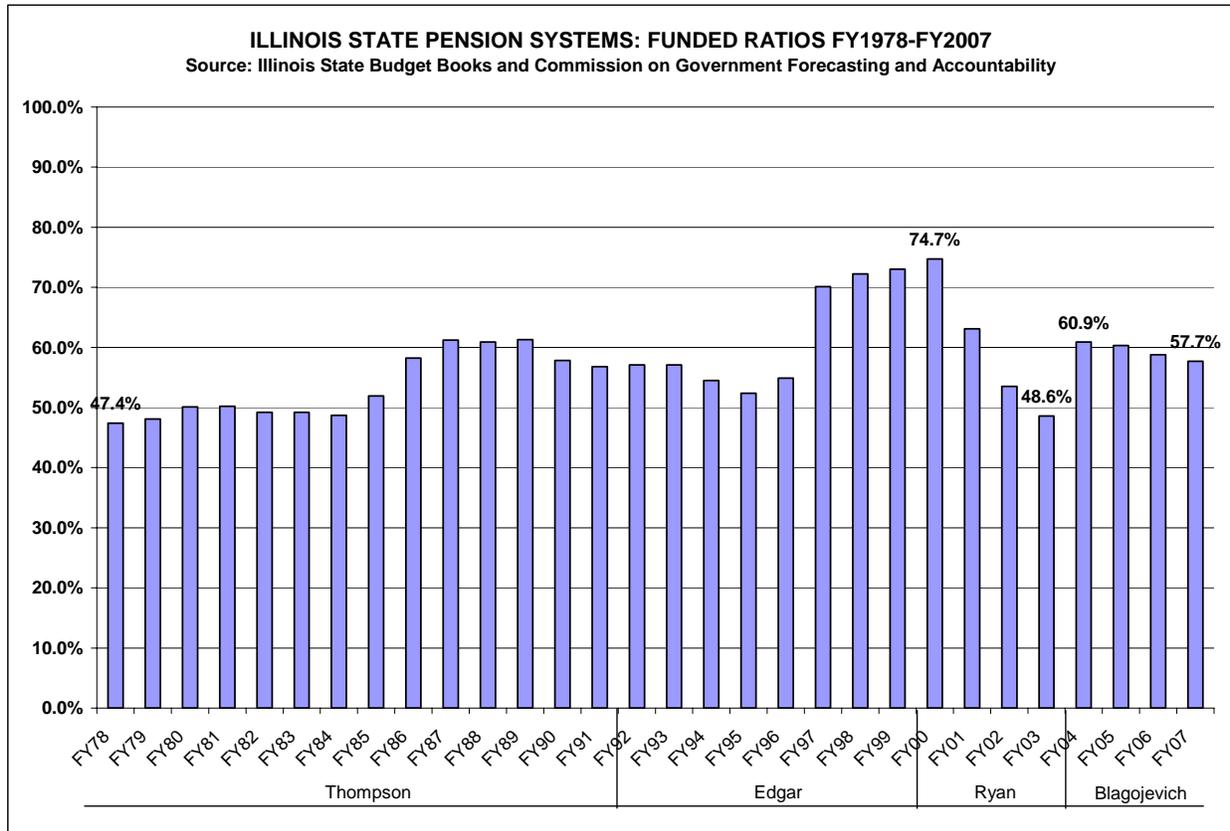
Because of Illinois' historic problems with underfunding its pension systems, recent Illinois governors have championed pension reform. Governor Edgar successfully won legislative approval of a funding reform law in 1994 that required the State to fund its pensions at a level to reach 90% by 2045. Governor Blagojevich won legislative approval and issued \$10 billion in pension obligation bonds. He also secured approval for the implementation of several structural reforms initially proposed by a Blue Ribbon Pension Commission.

### **Historic Funded Ratios and Unfunded Liabilities**

The exhibit below shows funded ratios for the five Illinois retirement systems from FY1978 to FY2007. The funded ratio represents the amount of retirement system liabilities that are covered by assets. A well funded system will have a funded ratio of 80% or more. The highest funded ratio for the State's pension funds over the thirty years reviewed was in FY2000, when the funded ratio was 74.3%.

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<sup>1</sup> Standard & Poor's. *Rising U.S. Unfunded Pension Liabilities are Causing Budgetary Stress*, February 22, 2006.



The funded ratio of the five retirement systems will fall to 57.7% in FY2007 and unfunded liabilities will rise to nearly \$45.8 billion, according to recent projections from the Commission on Government Forecasting and Accountability. Between FY2003 and FY2007, the funded ratio for all funds will increase from 48.6% to 57.7%. However, the funded ratio has fallen each year since FY2004. In that year the funded ratio increased dramatically because of the infusion of the proceeds of the \$10 billion Pension Obligation bonds. Some of the subsequent decline is due to the impact of the Early Retirement Initiative funding fiasco in FY2002, which increased liabilities.<sup>2</sup> But the two-year partial pension holiday in FY2006 and FY2007, which reduced contributions from the originally certified amount required under the 1995 funding reform law by \$2.3 billion, has undoubtedly exacerbated the situation.

Between FY2006 and FY2007:

- The projected funded ratio for the State Employees' Retirement System will decline from 52.6% to 51.4%;
- The projected funded ratio for the Teachers' Retirement System will fall from 59.5% to 58.6%;
- The State Universities Retirement System projected ratio will decline from 63.9% to 62.5%;

<sup>2</sup>The original estimated annual cost of amortization of the FY2002 Early Retirement Initiative was \$70 million. However, a recalculation has shown that there were serious errors in that estimate, and that the actual annual cost will be \$382 million. The State has opted to spread out the cost of paying for the ERI over 40 years. These costs are included in the calculation of estimated contributions to the retirement systems over time.

- The Judges' Retirement System projected ratio will decrease from 44.7% to 43.4%; and
- The General Assembly Retirement System will remain constant at 37.2%.

<b>ILLINOIS STATE RETIREMENT SYSTEMS: FUNDED RATIOS</b>					
	<b>FY2003*</b>	<b>FY2004</b>	<b>FY2005</b>	<b>FY2006 Estimate</b>	<b>FY2007 Estimate</b>
State Employees' Retirement System	42.6%	54.2%	54.4%	52.6%	51.4%
Teachers' Retirement System-Downstate	49.3%	61.9%	60.8%	59.5%	58.6%
State Universities Retirement System	53.9%	66.0%	65.6%	63.9%	62.5%
Judges' Retirement System	30.7%	46.2%	45.7%	44.7%	43.4%
General Assembly Retirement System	25.3%	40.1%	39.1%	37.2%	37.2%
<b>ALL STATE RETIREMENT SYSTEMS</b>	<b>48.6%</b>	<b>60.9%</b>	<b>60.3%</b>	<b>58.8%</b>	<b>57.7%</b>

\*Does not include proceeds of Pension Obligation Bonds on a pro forma basis.

Source: Commission on Government Forecasting and Accountability. *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, pp. 7-21.

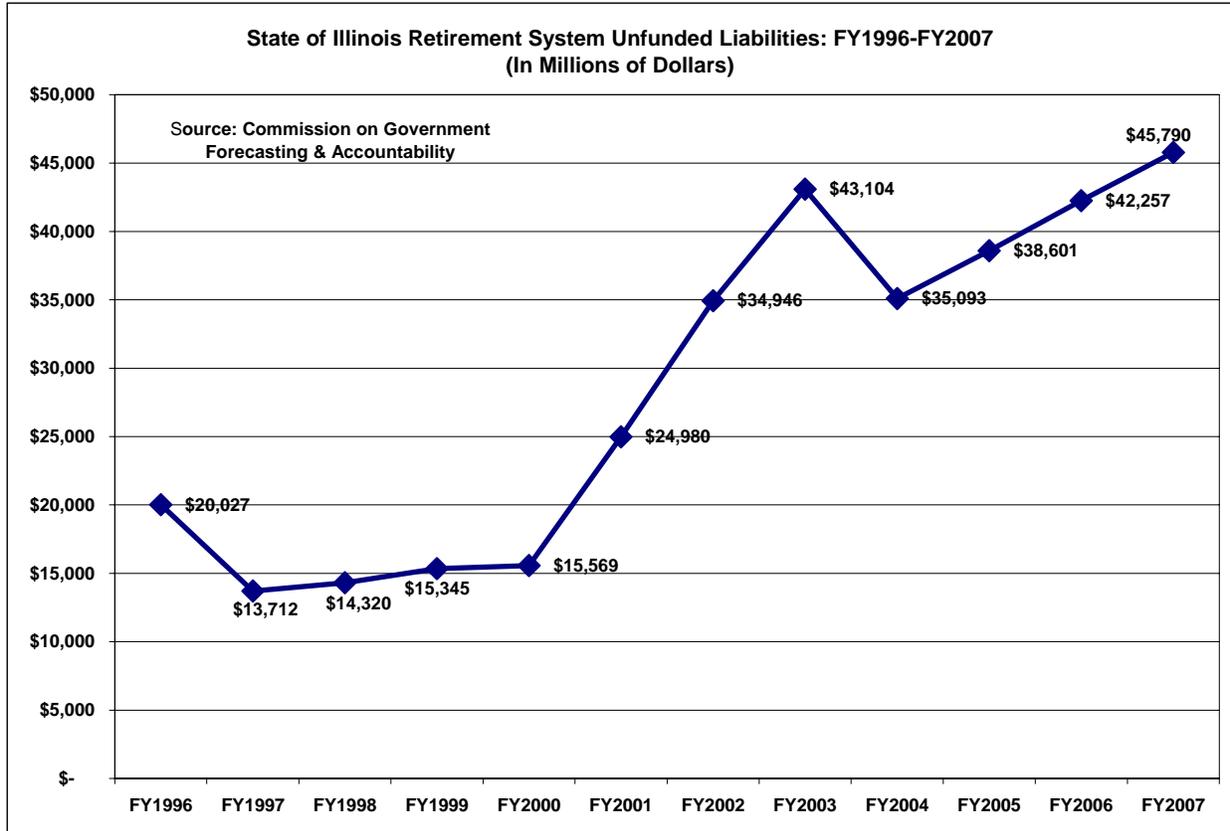
According to the Commission on Government Forecasting and Accountability, the unfunded liabilities of the State's five pension funds are projected to be nearly \$45.8 billion in FY2007. This is approximately a 6.2%, \$2.6 billion increase over FY2003, when unfunded liabilities were \$43.1 billion.

<b>STATE PUBLIC EMPLOYEE RETIREMENT SYSTEMS UNFUNDED LIABILITIES (FY03-FY07) - \$ Millions</b>							
<b>RETIREMENT SYSTEM</b>	<b>FY2003</b>	<b>FY2004 Estimate</b>	<b>FY2005 Estimate</b>	<b>FY2006 Estimate</b>	<b>FY2007 Estimate</b>	<b>\$ CHG FY03-FY07</b>	<b>% CHG FY03-FY07</b>
<b>State Employees'</b>	\$ 10,091.9	\$ 8,452.5	\$ 8,810.5	\$ 9,586.0	\$ 10,328.0	\$ 236.1	2.3%
<b>Teachers' Retirement</b>	\$ 23,808.6	\$ 19,402.8	\$ 21,989.8	\$ 24,117.6	\$ 26,207.3	\$ 2,398.7	10.1%
<b>State Universities</b>	\$ 8,310.4	\$ 6,495.3	\$ 6,999.6	\$ 7,698.7	\$ 8,337.1	\$ 26.7	0.3%
<b>Judges'</b>	\$ 746.1	\$ 621.5	\$ 671.5	\$ 718.9	\$ 774.2	\$ 28.1	3.8%
<b>General Assembly</b>	\$ 146.5	\$ 124.4	\$ 129.6	\$ 135.6	\$ 143.8	\$ (2.7)	-1.8%
<b>TOTAL</b>	<b>\$ 43,103.8</b>	<b>\$ 35,096.5</b>	<b>\$ 38,601.1</b>	<b>\$ 42,256.8</b>	<b>\$ 45,790.4</b>	<b>\$ 2,686.6</b>	<b>6.2%</b>

Source: Commission on Government Forecasting and Accountability.

FY2003 calculations do not include proceeds of the Pension Obligation bonds.

The next exhibit presents a twelve-year trend of unfunded liabilities in the State's five retirement systems. It shows that since FY1996, unfunded liabilities have grown by 128.6% or \$25.7 billion. This represents an increase from \$20.0 billion to nearly \$45.8 billion.



### Reasons for Chronic Underfunding of Retirement Systems: 1970-2003

The principal reasons for the State of Illinois' historic failure to fund its pension systems in an actuarially sound manner over time are outlined below. All calculations are from the 2005 *Governor's Pension Commission: Pension Reform Report and Recommendations for Governor Rod Blagojevich*.

*Contribution Shortfalls.* For over thirty years, annual State contributions have been less than the necessary amount (the interest and current costs) determined by the retirement systems' actuaries. The State of Illinois' contribution shortfall totaled \$10.6 billion between 1995 and June 2003. This increased the amount of underfunding.

*Investment Losses.* The State pension funds experienced investment losses of \$6.4 billion between 1995 and 2003. Investment returns are a significant part of the funding stream of a retirement system. This problem has been exacerbated by the practice of failing to make adequate contributions to the funds.

*Failure to Increase Payments in 1990s Economic Boom.* After implementation of the 1995 law, annual funding decisions adhered to a fixed, ramped-up payment schedule but did not adjust for the cyclical opportunity provided by the long 1990s economic expansion to contribute in excess

of the fixed payment amounts provided for in the 1995 funding law. This was a lost opportunity to improve the funding situation.<sup>3</sup>

*Increased Benefits.* Between FY1995 and FY2003, Governors Edgar and Ryan, with encouragement from succeeding General Assemblies, weakened the impact of the pension funding reform law by adding \$5.8 billion in new pension benefit enhancements. This further increased the State’s aggregate pension liabilities.

<b>ILLINOIS STATE PENSION ENHANCEMENTS: 1995-2003</b>		
<b>YEAR</b>	<b>BENEFIT</b>	<b>TOTAL COST</b>
1995	TRS Early Retirement Incentive	\$ 150,000,000
1997	SURS Conversion from Step Rate to Flat Formula	\$ 180,000,000
1998	TRS Conversion from Step Rate to Flat Formula	\$ 1,000,000,000
1998	SERS Conversion from Step Rate to Flat Formula; Alternative formula final rate of pay conversion from average of final 4 years to pay on final day	\$ 1,250,000,000
2001	SERS Rule of 85 added; alternative formula conversion from Step Rate to Flat Formula	\$ 650,000,000
2002	SURS added 30 years of service and out provision	\$ 60,000,000
2002	SERS added highway maintainers and DHS security to alternative formula	\$ 170,000,000
2003	SERS Early Retirement Incentive	\$ 2,370,000,000
<b>TOTAL</b>		<b>\$ 5,830,000,000</b>

Source: FY2006 Illinois State Budget, p. 2-2.

*FY2002 Early Retirement Initiative Costs.* One of the biggest contributors to increased retirement costs in recent years was the Early Retirement Incentive (ERI) offered to state workers in FY2002. The original estimated annual cost of the amortization of the ERI was \$70 million. However, errors in that estimate have led to a recalculation that the actual annual cost will be \$382 million.

The full cost of the ERI was originally assumed to be \$622 million in additional unfunded pension liabilities, or approximately \$80,000 per employee. However, new calculations increased that amount to approximately \$2.5 billion or \$200,000 per employee. This represents an estimated \$1.8 billion error.

What were the reasons underlying the dramatic increase in early retirement benefit costs? First, instead of accruing a retirement benefit equal to 1.67% of their final paycheck for the first ten years of service, as is usually the case, retirees in “high stress” jobs such as public safety positions were credited with a 2.5% accrual rate. Approximately one third of state employees are classified as working in “high stress” positions. For all other employees, the ERI package waived the penalty that normally would have reduced annual pension payments by 6% for each year an employee was less than 60 years of age at the time of retirement. Therefore, a 50-year-

<sup>3</sup> See *The Governor’s Pension Commission: Pension Reform Report And Recommendations for Governor Rod Blagojevich*, February 11, 2005, pp. 8-9

old employee would reap the same benefits as a 60-year-old employee. These two changes added costs of approximately \$62,000 per employee, boosting the average ERI cost of \$80,000 to \$142,000.<sup>4</sup>

The two changes described above also encouraged younger workers to retire. In fact, about half of retirees were 55 or younger. Consequently, the State has to pay this groups' retirement costs for a longer period of time than is usually the case because they live longer in retirement, thereby further boosting costs. The ERI also had provisions allowing retirees to purchase additional years of service. These two additional factors added an average of \$58,000 in costs per retiree for a total average cost of \$200,000.<sup>5</sup>

*Partial Pension Holiday FY2006-FY2007.* The General Assembly approved legislation (P.A. 94-0004) authorizing reductions in the State contributions from the originally certified amounts to the five State retirement systems in FY2006 and FY2007 totaling \$2.3 billion.

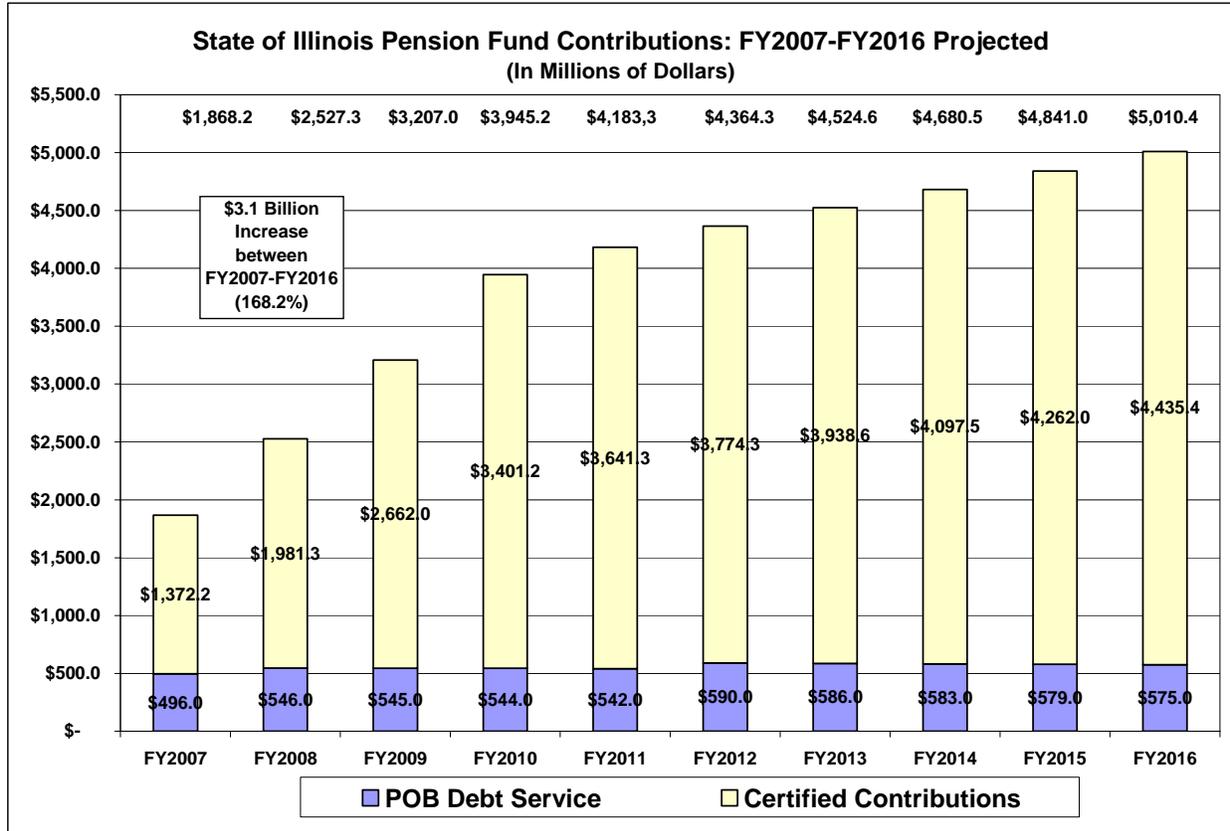
### **FY2007 and Beyond: The Pension Funding Crisis Will Worsen**

The pension funding crisis is not going away. In fact, from a budgetary standpoint it will get much worse in the future. If the State complies with the current law and continues makes the full certified contributions for the next ten years, the annual required payment in FY2016 will have increased by 223.2%. That is a \$3.06 billion increase from \$1.37 billion to \$4.43 billion. When the debt service payments on the pension obligation bonds are factored in, the amount of increase is \$3.14 billion, or from \$1.86 billion to \$5.01 billion. This represents a 168.2% increase.

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<sup>4</sup> Information on the cost of the early retirement initiative is from Greg Burns, "Pension Debacle Grows," in *Chicago Tribune*, March 28, 2004.

<sup>5</sup> Greg Burns, "Pension Debacle Grows," in *Chicago Tribune*, March 28, 2004.



If State budget appropriations grow at a rate of 5% per year over the next ten years and the State makes the full certified contributions, the percentage of total appropriations reserved for pensions (including debt service on pension obligation bonds) will rise from 4.1% in FY2007 to 7.1% in FY2016.

<b>State Pension Expenses as a Percentage of Future Operating Budgets</b>					
	All Funds	POB Debt Service*	Certified Contributions	Total Pension Expenses	% of Total Budget
FY2007	\$ 45,427.7	\$ 496.0	\$ 1,372.2	\$ 1,868	4.1%
FY2008	\$ 47,699.1	\$ 546.0	\$ 1,981.3	\$ 2,527	5.3%
FY2009	\$ 50,084.0	\$ 545.0	\$ 2,662.0	\$ 3,207	6.4%
FY2010	\$ 52,588.2	\$ 544.0	\$ 3,401.2	\$ 3,945	7.5%
FY2011	\$ 55,217.7	\$ 542.0	\$ 3,641.3	\$ 4,183	7.6%
FY2012	\$ 57,978.5	\$ 590.0	\$ 3,774.3	\$ 4,364	7.5%
FY2013	\$ 60,877.5	\$ 586.0	\$ 3,938.6	\$ 4,525	7.4%
FY2014	\$ 63,921.3	\$ 583.0	\$ 4,097.5	\$ 4,681	7.3%
FY2015	\$ 67,117.4	\$ 579.0	\$ 4,262.0	\$ 4,841	7.2%
FY2016	\$ 70,473.3	\$ 575.0	\$ 4,435.4	\$ 5,010	7.1%

\* Principal + Interest

Note: Assumes 5% annual appropriation growth

Source: Certified pension contribution data from Commission on Government Forecasting and Accountability; POB debt service figures from FY2007 Illinois State Budget, p. 12-13.

## **ATTEMPTED SOLUTIONS: PENSION FUNDING REFORM EFFORTS**

There have been three major pension funding reform efforts in recent years: Governor Edgar's 1995 funding reform law, Governor Blagojevich's 2003 issuance of \$10 billion in pension obligation bonds, and the package of reforms adopted by the General Assembly in 2005 that were based in part on the recommendations of the Governor's Blue Ribbon Pension Commission.

### **The 1995 Pension Funding Reform Law**

The chronic underfunding of Illinois state pension funds created the impetus for enacting a funding reform law in 1994. Public Act 88-593 established a fifty-year schedule of funding requirements to compensate for the State's previous years of underfunding its pension plans. The law requires that the State's contribution "equal a percentage of payroll necessary to amortize 90% of unfunded liabilities" by the year 2044. The law went into effect in 1995.

The 1995 funding schedule was subsequently modified in 2005 by Public Act 94-0004, which introduced some pension reforms but reduced FY2006 and FY2007 required State contributions (see p. 17).

### **Issuance of \$10 Billion in Pension Obligation Bonds in 2003**

In his first year in office, Governor Blagojevich championed Public Act 93-0002, which authorized the issuance of \$10 billion of pension obligation bonds. The proceeds of these bonds were to be used to boost the pension funds' assets and reduce future unfunded liabilities.

Initially, the funds' managers and the governor's financial team estimated that the pension funds would earn investment income at the traditional long-term actuarial rate of 8.5% and that the pension bond proceeds would earn at least that rate over the thirty-year life of the bonds. The financial team forecasted that economic savings would result from issuing the \$10 billion in bonds at the then-current market rate of approximately 5.8%, as long as the funds earned a long-term actuarial rate of 8.0%. In fact, the bonds were ultimately issued at an interest rate of 5.05% while the pension funds' actuaries ultimately projected an 8.5% expected rate of return for the entire asset portfolio. The State estimated that it would capture \$860 million in additional "savings" from these favorable rates. In the FY2005 budget, the State proposed to capture \$215 million, or 25% of the increase, reserving the remainder for capture in future years. The \$215 million "savings" was used as the basis for reducing the State's pension contribution by a like amount in FY2005.

### *Civic Federation Position on the Pension Obligation Bond Issue*

The Civic Federation supported Governor Blagojevich's proposal to issue long-term debt to meet the State's past pension obligations. The Civic Federation has traditionally cautioned governments against using long-term debt to address budget shortfalls. However, the Federation

recognized the extraordinarily difficult financial position of Illinois and most other state governments and saw benefits in securitizing a portion of the unfunded liability such that the State could not avoid payment upon it without jeopardizing existing bond covenants. As a result of the dire budget conditions of the State, past funding inadequacies, and historically low interest rates, the Federation supported the pension obligation bond issue but cautioned that all proceeds should be applied to past liabilities.

The Civic Federation strongly warned against the practice of debt financing to correct ordinary budget shortfalls or to fund normal operations, which would traditionally include current pension obligations. (Ultimately, the State used a portion of the bond proceeds to pay part of the FY2003 pension contributions and all of the FY2004 contributions.) The Civic Federation's support of the governor's pension obligation bond proposal was tied to our acknowledgment that the State's pension obligations are compounding dramatically because of past failures to adequately fund the pension plans on a continuing basis.

While supporting the governor's use of pension obligation bonds, The Civic Federation offered the following concerns and suggestions:

- Projecting that the State's pension funds will earn investment returns of 8% or more is optimistic in light of current and foreseeable market performance.
- The General Assembly and the public at large should be aware that this financial strategy would not eliminate all the problems associated with the funding of State pensions.
- The Civic Federation strongly encourages the General Assembly to be mindful of the benefit levels granted to employees.
- The General Assembly should seriously consider extending the maximum permitted maturity of its debt to match the economic life of the objects secured by its expenditures.
- The State should also consider authorizing cost effective, contemporary borrowing techniques such as variable rate obligations.

### **Governor's Blue Ribbon Pension Commission Recommendations**

In his second year in office, Governor Blagojevich appointed a thirteen-member Blue Ribbon Pension Commission composed of representatives from the General Assembly, business, labor and civic groups including Laurence Msall of the Civic Federation. The Commission was chaired first by James Annabel of the Federal Advisory Council and later by former Illinois Attorney General Roland Burriss. The Commission's charge was threefold:

1. To study the causes of the State Retirement Systems' current underfunded position, the pension plan provisions, the use of pension obligation bonds, other types of pension plans, alternative funding formulas, and related issues.
2. To establish a set of guiding principles for State pension funding.
3. Based on those principles, to develop specific recommendations for changes to State pension plan provisions and pension funding in order to ameliorate the Retirement Systems' poor financial status.

The Commission issued its first report in February 2005. Initial estimates from the Retirement Systems' actuaries and consultants from Deloitte Consulting LLP indicated that implementing some of the Commission's recommendations could reduce the Retirement Systems' actuarial accrued liability in 2045 by \$145.5 billion, or 28%, from \$521.5 billion to \$376.0 billion.<sup>6</sup>

The Pension Commission's February 2005 report made the following recommendations, most of which were adopted by Governor Blagojevich and included in his State Budget Address to the General Assembly. However, he did modify several of the recommendations (see section following).

*Limit Automatic Annual Increase to 2% or CPI (New Hires Only)*

The current rate of automatic increase for retirement annuities was 3% per year. Other retirement systems index the rate of increase to the CPI, limit the dollar amount of increase, or approve new increases annually.

Proposal: For new hires only, limit automatic increases to the lesser of the change in CPI or 2%.

Savings Projected: Accrued liabilities would be reduced in the year 2045 by \$74.2 billion. The State would save \$4.76 billion in contributions.

*Cap the State's Obligation to Assume Pension Costs for End-of-Career Salary Increases*

School district and universities were permitted to grant faculty and administrators large salary increases in the final years of their career. Pension benefits for these employees are based on the salary received in the final four years of employment. Because the State assumes the cost of these pension increases through the Teachers Retirement System and State Universities Retirement System (SURS), these costs gave risen substantially over time.

Proposal: For purposes of determining the State's share of pension benefits only, cap end-of-career employee raises at no more than 5% per year. School districts and universities would assume the burden of paying for pension increases above the 5% cap.

Savings Projected: Accrued liabilities would be reduced in the year 2045 by \$19.47 billion. The State would save \$16.2 billion in contributions.

*Recalculate the Money Purchase Option Interest*

The SURS Board determined the interest rate applied to employee contributions for money purchase option calculations based on its interpretation of relevant statutes. During the five-year period ending June 30, 2004, the SURS Board determined the applicable interest rate was 9% even though the actual rate of return for SURS investments was less than 3.3%.

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<sup>6</sup> *The Governor's Pension Commission: Pension Reform Report and Recommendations for Governor Rod Blagojevich*, February 11, 2005, p. 2. Specific calculations of savings projections and liability reductions can be found in Appendix B of the Pension Commission Report.

Proposal: Define the interest credit under the Money Purchase Option as the long-term rate of return, but not to exceed either the most recent five- or ten-year rates of return.

Savings Projected: Accrued liabilities would be reduced in the year 2045 by \$2.25 billion. The State would save \$5.47 billion in contributions.

*Change Retirement Ages (New Hires Only)*

Members of the State's retirement systems are eligible for full retirement benefits when they attain age 60, unlike most private sector retirement systems that require retirement at age 65.

Proposal: Increase the eligibility for full benefits to age 65, with eight years or more of service; age 62 with thirty years or more of service; or age 60 with 35 years or more of service.

Currently, employees enrolled in the Teachers Retirement System may attain a maximum retirement benefit that is 75% of the average salary of the four highest consecutive salary rates within the last ten years of creditable service if they have completed 34 years of service.<sup>7</sup> Members of the State Employees Retirement System also receive a maximum retirement benefit of 75%; the amount is based on the average salary during a 48 consecutive month period within the last 120 months of service in which compensation was the highest.<sup>8</sup>

Savings Projected: Accrued liabilities would be reduced in the year 2045 by \$30.9 billion. The State would save \$11.51 billion in contributions.

*Eliminate Money Purchase Option for SURS Annuitants (New Hires Only)*

Members of the State Universities Retirement System (SURS) were permitted to have their benefits calculated under basic plan provisions or the Money Purchase Option and opt for that calculation which brings the higher benefit.

The Money Purchase Option aggregates employee contributions and provides an annual interest credit, which is determined by the SURS Board. When the employee retires, the accumulated contributions plus interest are then marched by the State at 140%.

Proposal: For new hires only, eliminate the Money Purchase Option.

Savings Projected: Accrued Liabilities would be reduced in the year 2045 by \$4.73 billion. The State would save \$1.18 billion in contributions.

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<sup>7</sup> FY2005 Illinois Teachers Retirement System Comprehensive Annual Financial Report, p. 32.

<sup>8</sup> FY2005 Illinois State Employees Retirement System Comprehensive Annual Financial Report, p. 19.

### *Limit Eligibility for Alternative Formula Pension Benefits (New Hires Only)*

The State Employees Retirement System (SERS) provided a higher benefit formula and earlier retirement eligibility for certain employees in “high risk” jobs. However, the high risk category has been expanded over time from sworn police officers to one-third of all state workers.

Proposal: Limit the alternative formula to police officers and employees who meet defined risk criteria.

Savings Projected: Accrued liabilities would be reduced in the year 2045 by \$13.96 billion. The State would save \$1.36 billion in contributions.

### *No New Pension Benefits without Funding*

One of the reasons for the steady increases in unfunded liabilities over time is the practice by succeeding Governors and General Assemblies of approving increases in retirement benefits without also providing for additional funding to pay for those new benefits.

Proposal: No new benefits for state employees without a new funding source identified at the time of adoption. An explicit sunset provision should be attached to any new pension benefit.

Savings Projected: No estimate provided.

### *Increase Employee Contributions by 1%*

Employees covered by the State retirement systems contribute a percentage of their compensation for their own pensions and to fund survivor’s benefits. For example, members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:

- Members with Social Security: 3.5% of compensation (pension) + .5% (survivors’) = 4.0% total
- Members without Social Security: 7.0% of compensation (pension) + 1.0% (survivors’) = 8.0% total

Proposal: Increase employee contributions to each of the five retirement systems by 1%.

Savings Projected: The State would save \$13.72 billion in contributions between 2006 and 2045.

### *Examine Opportunities for Conversion to Defined Contribution Retirement System*

With the exception of some employees in the State Universities Retirement System who have opted to enroll in a defined contribution retirement plan, most State of Illinois employees are enrolled in defined benefit plans.

Proposal: The Commission proposed that the State examine the costs and benefits of shifting State of Illinois employees from the current defined benefit retirement plan to a defined contribution plan.

### **The Pension Funding Plan Adopted for FY2006 and FY2007**

The State of Illinois pension funding plan ultimately adopted by the General Assembly in the FY2006 budget incorporated some of the governor's original proposals but coupled those with the forecasted savings from a two year, \$2.3 billion partial State pension contribution holiday.

#### *The Governor's Original FY2006 Budget Proposal*

Governor Blagojevich accepted most of the Pension Commission's recommendations, though he did modify several of them. Two concepts considered by the Pension Commission were explicitly rejected by the administration:

- Requiring employees to increase the percentage of salary they pay into the retirement systems, and
- Any consideration of shifting from a Defined Benefit (DB) to a Defined Contribution (DC) Plan.

#### Proposals Accepted in Full

The governor accepted the following Commission recommendations in full and incorporated them into his FY2006 budget proposal:

- Recalculate the Money Purchase Option Interest
- Change Retirement Ages (New Hires Only)
- Eliminate Money Purchase Option for SURS Annuitants (New Hires Only)
- Limit Eligibility for Alternative Formula Pension Benefits (New Hires Only)

#### Proposals Modified

The governor accepted the following Commission recommendations in spirit but modified some of their provisions.<sup>9</sup>

##### *Limiting Automatic Annual Increases (New Hires Only)*

- For new hires only, automatic increases would be limited to the lesser of the change in CPI or 3% and apply only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.
- Difference from Commission Recommendation: The Commission had recommended that the annual rate of automatic increase be limited to 2% or CPI.

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<sup>9</sup> The following contribution savings estimates are taken from the governor's February 16, 2005 budget press release [www.illinois.gov/PressReleases/PressReleasesListShow.cfm?RecNum=3699](http://www.illinois.gov/PressReleases/PressReleasesListShow.cfm?RecNum=3699) .

- Projected Savings: \$19 billion in state pension contributions over forty years.

*Capping the State's Obligation to Assume Pension Costs for End-of-Career Salary Increases*

- For purposes of determining the State's share of pension benefits only, end-of-career employee raises would be capped at 3% per year. School districts and universities would assume the burden of paying for pension increases above the 3% cap.
- Difference from Commission Recommendation: The Commission had recommended that end-of-career employee raises would be capped at no more than 5% per year
- Projected Savings: \$17 billion in state pension contributions over forty years

*No New Pension Benefits without Funding*

- The Governor has reintroduced his Balanced Budget Act which would require that any appropriation bill that includes new spending would require identification of new revenues or reduced spending in order to pay for the initiative.
- Difference from Commission Recommendation: No sunseting of new pension enhancements.

Savings Originally Projected from the Adoption of the Pension Funding Reforms

Actuaries and consultants for the Governor's Office of Management and Budget estimated that adoption of the reform proposals in the FY2006 budget would generate approximately \$55 billion in cost savings over forty years. The cost savings were expected to accrue because of reductions in State contributions to the five retirement systems required to meet the 90% funded ratio goal by 2045. Over forty years, the reforms are expected to reduce pension fund liabilities by \$100 billion.

*The Proposals Ultimately Adopted by the General Assembly: Public Act 94-0004*

The General Assembly approved a few of the Governor's proposed reforms with some modifications. The most significant proposals enacted into law capped end of year salary increases, eliminated the State Universities Retirement Systems money purchase option for new hires, limited eligibility for alternative formulas and required funding for enhanced benefits. The legislators rejected proposals to:

- Change the eligibility for full benefits to age 65, with eight years or more of service; age 62 with thirty years or more of service; or age 60 with 35 years or more of service.
- Limit automatic benefit increases for new hires to the lesser of the change in CPI or 3% and apply increases only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.

The new proposals approved by the legislature and signed into law by the governor in Public Act 94-0004 included a two-year deferral of \$2.3 billion in pension contributions.

The exhibit below presents a comparison of the governor's FY2006 original pension funding proposals as well as new proposals that were advanced during the legislative session and the final action taken by the General Assembly.

<b>FY2006 PENSION FUNDING REFORMS</b>	
<b>GOVERNOR'S ORIGINAL PROPOSALS</b>	<b>STATUS IN FINAL BUDGET</b>
Cap End of Year Salary Increases to 3%	6% Annual Cap Adopted
Eliminate SURS Money Purchase Option (New Hires)	Approved
Recalculate Money Purchase Interest Rate to Reflect Long-Term Rate of Return, not 9%	Authorized Comptroller to Set Rate
No New Benefits w/o Funding	Approved
Limit Alternative Formula Benefits (New Hires)	Approved
Limit Automatic Increases to CPI	Not Approved
Change Retirement Age (New Hires)	Not Approved
<b>NEW PROPOSALS</b>	
Defer Pension Contributions by \$2.3 Billion over 2 Years	Approved
Create Task Force to Study Pension Reform	Approved
Create Cost Neutral Early Retirement Program Paid for by Local Employers/Beneficiaries	Approved
Eliminate Lump Sum Awards for Unearned Sick Pay to Boost Pensions	Approved

Public Act 94-0004 also created a second Blue Ribbon Task Force made up of union officials and legislators to further study pension reform proposals not yet enacted.

The governor's second Blue Ribbon Commission on Pensions subsequently made a number of pension reform recommendations. The Civic Federation agrees with four of the Commission's findings that focus on identifying or securing dedicated revenues to fund the retirement systems and regularly reviewing pension benefits:

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the State sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.
3. The General Assembly should explore new dedicated revenue sources for the retirement systems.
4. The legislature should regularly review the pension systems' provisions regarding benefits and make determinations as needed.

The fifth recommendation, however, proposes that the State consider issuing additional Pension Obligation bonds to further reduce pension costs as long as market conditions are favorable and as long as POB issuance is part of a broader plan to reduce the retirement systems' unfunded liabilities. Absent any ironclad commitment by the governor or legislature to actually fund the retirement systems at their certified level, the Civic Federation is not convinced that issuing additional debt would in fact improve the funding situation. An influx of bond money might unfortunately become another excuse to reduce budgetary contributions to the retirement systems.

*Financial Impact of Funding Reforms Adopted and 2-Year Partial Pension Funding Holiday*

The exhibit below shows the difference between the original certified required contribution for each State pension fund and the amount to be appropriated in FY2006 and FY2007 according to P.A. 94-0004. The amounts include calculations of savings from the funding reforms ultimately adopted for FY2006 as well as the partial pension holiday also adopted at that time.

P.A. 94-0004 approved reductions in the State contributions from the originally certified amounts to the five State retirement systems in FY2006 and FY2007 totaling \$2.3 billion. In accordance with that statute, the governor proposed to contribute nearly \$1.4 billion to the State's retirement funds in FY2007, which was \$1.1 billion less than the certified contribution amount. The administration also proposed that any revenues derived from the sale of State assets or the tenth casino license be used to reduce pension fund liabilities.

FY2006 & FY2007 CERTIFIED CONTRIBUTIONS VS. FINAL GENERAL ASSEMBLY APPROPRIATIONS (In Millions of Dollars)								
System	FY2006			FY2007			Total 2-Year Contributions	Total Reduction
	Certified Contributions	P.A. 94-0004	Difference	Certified Contributions	P.A. 94-0004	Difference		
TRS	\$ 1,058.5	\$ 531.8	\$ 526.7	\$ 1,233.1	\$ 735.5	\$ 497.6	\$ 2,291.6	\$ 1,024.3
SERS	\$ 690.3	\$ 203.8	\$ 486.5	\$ 832.0	\$ 344.2	\$ 487.8	\$ 1,522.3	\$ 974.3
SURS	\$ 324.9	\$ 166.6	\$ 158.3	\$ 391.9	\$ 252.1	\$ 139.8	\$ 716.8	\$ 298.1
JRS	\$ 38.0	\$ 29.2	\$ 8.8	\$ 44.5	\$ 35.2	\$ 9.3	\$ 82.5	\$ 18.1
GARS	\$ 5.5	\$ 4.2	\$ 1.3	\$ 6.3	\$ 5.2	\$ 1.1	\$ 11.8	\$ 2.4
<b>Total</b>	<b>\$ 2,117.2</b>	<b>\$ 935.6</b>	<b>\$ 1,181.6</b>	<b>\$ 2,507.8</b>	<b>\$ 1,372.2</b>	<b>\$ 1,135.6</b>	<b>\$ 4,625.0</b>	<b>\$ 2,317.2</b>

Source: Commission on Government Forecasting and Accountability. Report on the 90% Funding Target of Public Act 88-0593.

*Financial Impact of Pension Funding Changes Adopted in FY2006 to FY2045*

The actuaries of the General Assembly's Commission on Government Forecasting and Accountability (CGFA) and the five retirement systems have each prepared estimates of the long-term economic impact of the FY2006 pension funding reforms. The results of those analyses are shown below.

The CGFA estimates that the final pension program approved for FY2006 will cost the State an additional \$4.7 billion and reduce actuarial liabilities by \$38.6 billion over forty years. The retirement systems' actuaries estimate that \$6.8 billion more in costs will be incurred and the liabilities will be reduced by \$44.6 billion. The State originally projected that pension liabilities would be reduced by approximately \$55 billion if all of the governor's proposed reforms were adopted. In contrast, the reforms proposed by the first Blue Ribbon Pension Commission had been estimated at a value of \$145.5 billion in reduced liabilities and \$54.2 billion in reduced State contributions.

ACTUARIAL ESTIMATES OF INCREASES IN STATE CONTRIBUTIONS: FY2006-FY2045						
Total Projected State Contributions for FY2006-FY2045						
Prepared by CGFA (\$Millions)						
State Contributions	TRS	SERS	SURS	JRS	GARS	TOTAL
Pre P.A. 94-0004	\$ 160,302	\$ 68,065	\$ 61,184	\$ 6,538	\$ 862	\$ 296,951
P.A. 94-0004	\$ 155,507	\$ 78,068	\$ 60,531	\$ 6,654	\$ 877	\$ 301,637
Difference	\$ (4,795)	\$ 10,003	\$ (653)	\$ 116	\$ 15	\$ 4,686

Total Projected State Contributions for FY2006-FY2045						
Prepared by Retirement Systems (\$Millions)						
State Contributions	TRS	SERS	SURS	JRS	GARS	TOTAL
Pre P.A. 94-0004	\$ 156,715	\$ 65,340	\$ 60,688	\$ 6,538	\$ 862	\$ 290,143
P.A. 94-0004	\$ 152,550	\$ 75,928	\$ 60,914	\$ 6,654	\$ 877	\$ 296,923
Difference	\$ (4,165)	\$ 10,588	\$ 226	\$ 116	\$ 15	\$ 6,780

Source: Commission on Government Forecasting and Accountability. August 2005.

ACTUARIAL ESTIMATES OF PENSON FUND LIABILITY REDUCTIONS: FY2006-FY2045						
	TRS	SERS	SURS	JRS	GARS	TOTAL
CGFA	\$ 26,265	\$ 667	\$ 11,690	\$ -	\$ -	\$ 38,622
Retirement Systems Actuaries	\$ 34,322	\$ 675	\$ 9,655	\$ -	\$ -	\$ 44,652

Source: Commission on Government Forecasting and Accountability. August 2005.

### Civic Federation Reaction to Pension Funding Proposals in FY2006 & FY2007 Budgets

The Civic Federation devoted a large part of its analyses of the State of Illinois' FY2006 and FY2007 budgets to discussions of pension issues.

#### Support for Originally-Proposed FY2006 Pension Funding Reforms

The Civic Federation strongly supported the pension reforms originally proposed by Governor Blagojevich. The State of Illinois' pension costs are spiraling out of control, and swift legislative action was needed to reform the pension systems before their growing price tag financially overwhelmed the State. Without pension reform, there will be no tax increase big enough for the State to find more funds for education, transportation, and other priorities. In future years, the State will not be able to balance future budgets without substantial pension reforms. In the Federation's view, the reforms were the necessary first step toward putting State government on a solid financial footing.

While the Civic Federation supported the Governor's original pension funding reform proposals, it strongly objected to the final FY2006 budget which included a \$935 million partial pension holiday.

#### Opposition to FY2007 State Budget Because of the Two-Year Partial Pension Holiday

The Civic Federation **opposed** Governor Blagojevich's FY2007 \$45.4 billion operating budget because it was built on a foundation that shortchanged the State's pension funds by \$1.1 billion.

This is the second year of an ill-considered \$2.3 billion partial pension funding shortfall brokered last year by the governor and legislative leaders.

At the same time as the budget failed to adequately fund the retirement systems, it proposed over \$1.0 billion in increased spending from General Fund revenues. The budget proposed as much as \$261 million in new initiatives, many of which represented recurring costs that could expand dramatically in future years. Deferring huge, ongoing pension obligations to pay for expensive new obligations that will entail recurring costs is short-sighted.

The consequences of the partial pension holiday are sobering. The retirement systems' funded ratio was projected to fall to 57.7% in FY2007. Since FY2004, when the State issued \$10 billion in pension obligation bonds for the express purpose of reducing the funds' outstanding liabilities, the funded ratio *will have fallen* from 60.9%. Between FY2006 and FY2007, unfunded liabilities will rise from \$42.2 billion to \$45.8 billion. The gains from the infusion of pension obligation bond funds and the approval of certain sorely needed reforms last year are being eroded.

### **CIVIC FEDERATION STATE PENSION FUND REFORM RECOMMENDATIONS**

The Civic Federation has offered the following additional recommendations over time on ways the State of Illinois could reduce its pension fund liabilities and obligations.

#### **Fund State Pension Systems at Certified Contribution Amount**

The State of Illinois has a responsibility to follow the mandate of the 1995 pension funding reform law. Deviating from the path laid out by that law renders it meaningless. Fixing the pension funding problem requires discipline and sacrifice. We urge the State to fund its pension obligations at the full amount required by the 1995 law each year. We do not believe that the State should increase recurring operating expenditures until it pays its existing, constitutionally-guaranteed obligations. Each time the State reduces contributions to the retirement systems, it is doing little more than deferring expense to future years.

#### **Impose a Moratorium on New Pension Enhancements**

The Civic Federation believes the time has come to stop expanding employee pension benefits. We call upon the legislature to reject and the governor to veto any new pension enhancements whether they are funded or not. In addition, the State must adopt a moratorium on any new benefit enhancements until such time as substantial progress has been made in reducing the State's billions of dollars in pension liabilities. This moratorium will likely be necessary for at least ten years, which was the length of time until the FY2002 Early Retirement Initiative was to originally be paid. However, the unexpected popularity and cost of the program—\$2.5 billion—pushed the General Assembly to spread the payments over forty years.

#### **Require Employees to Increase Pension Contributions by 1%**

Currently state employees contribute a percentage of the salary to the retirement funds.

- Members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:
  - Members with Social Security: 3.5% of compensation (pension) + .5% (survivors') = 4.0% total
  - Members without Social Security: 7.0% of compensation (pension) + 1.0% (survivors') = 8.0% total
- Members of the Teachers Retirement System contribute 9.0% of salary.
- Members of the State Universities Retirement System contribute 8.0% of salary except for SURS public safety employees, who contribute 9.5%.

The Civic Federation believes that all public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions. This increase should be required immediately for new hires and non-union employees. Although current contracts prevent this increase from being immediately implemented for employees covered by collective bargaining agreements, the State should, as a matter of policy, require increased contributions in future contracts. Stratospheric pension costs pose a serious threat to the financial future of the State of Illinois and its residents, and containing those costs must be a shared, ongoing, focused effort. We do not believe a single percentage point increase is onerous or unreasonable, especially when balanced against the generous retirement benefits state employees receive.

### **Study the Costs and Benefits of a Defined Contribution Pension Plan**

In reviewing the record of the past thirty years, we have seen no evidence that the General Assembly has the requisite fiscal discipline to transparently execute a well-funded defined benefit (DB) retirement system. For that reason, we think that a shift to a defined contribution (DC) system must be seriously considered for new hires when such a shift is deemed financially feasible. We understand that transition costs for the shift could be expensive because of the current dramatic underfunding of the retirement systems. However, the Civic Federation urges the governor and the legislature to undertake a study that will determine both the costs and benefits of this option. This study should include consideration of transition funding mechanisms because the cost savings and benefits of a shift to a DC plan in the long-term may outweigh short-term expenses. While the Civic Federation opposes the issuance of any new Pension Obligation bonds to fund current or future State pension obligations, it may make sense to issue such bonds for the sole purpose of paying the transition costs to a defined contribution plan. This possibility would be contingent, of course, upon financial feasibility and the identification of real, substantial cost savings over time.

## **Use Proceeds from Asset Sales or Long-Term Leases to Reduce Pension Liabilities**

In FY2007, the State of Illinois proposed the competitive sale of the Illinois Designated Account Purchase Program (IDAPP) student loan assets and loan transactions, in effect privatizing the management of the student loan portfolio in much the same manner as other states and the federal government have done. Revenue from the sale would be used to fund a proposed \$1,000 per student tuition tax credit. There were also some discussions of leasing the Illinois Toll Highway Authority. Credit Suisse estimates that leasing the Tollway could generate up to \$23.8 billion in revenue for the State.<sup>10</sup>

The Civic Federation supports the outsourcing of management functions for non-core functions of government with certain conditions. There must be an identifiable market of qualified vendors in the marketplace. The government must maintain adequate administrative oversight of the program after privatization to ensure that it fulfills its goals and operates as required under terms of the contract. However, we strongly oppose the use of one-time funds for recurring expenses, such as the governor's proposed tuition scholarship program. *A much more appropriate use of the one-time funds from a privatization deal would be to help reduce the massive unfunded liabilities of the State's chronically underfunded pension systems.*

## **The State Should Not Mandate Local Pension Enhancements without Providing Funding**

The General Assembly frequently approves legislation increasing the level and scope of local government employee pension benefits. However, no funding is provided for what amounts to yet another costly unfunded mandate for cash-strapped local governments. We believe that the concept of "pay as you go" funding adopted last year for State retirement system funding should be extended to include all State of Illinois actions that financially impact the pension costs of local governments. If the General Assembly sees fit to enhance benefits, it should identify and provide the requisite funding for those enhancements.

## **Provide Transparent and Frequent Reporting of Pension Fund Information**

The FY2007 Budget Book only provides information about the assets and liabilities of the State's retirement systems through FY2005. Traditionally, projections have been provided through the current budget year. This omission is disappointing and contrary to the transparency of much of the rest of the document.

The public needs full and accurate financial information in order to understand and evaluate the Governor's budget proposals, particularly on an important issue such as pension funding. The Civic Federation recommends that the State fully disclose all relevant financial information about contribution levels and funding status for all retirement systems in the Pension section of future Budget Books. We also call upon the Illinois Department of Financial and Professional Regulation to seek legislative approval for the annual reporting of public pension funds' activities and financial condition, and to extend the law to require disclosure of information by the Chicago Transit Authority Pension system.

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<sup>10</sup> "Leasing tollway could yield \$23 billion," *Chicago Tribune*, August 30, 2006.

## **Require a Balance of Interests in Pension Board Governance**

In reviewing public pension board composition in other states, The Civic Federation finds that many jurisdictions require pension governing boards to reflect a balance between employees, management, and citizens. Many others also require financial training or expertise for at least some of their trustees.<sup>11</sup> The Civic Federation believes that balance in pension board composition is critically important if Illinois is to confront and more equitably debate the escalating costs of public pensions. Consequently, it recommends the following reforms for public pension fund governance in Illinois and urges the General Assembly to take legislative action to:

- Balance employee and management representation on pension boards and
- Develop a tripartite structure that includes independent citizen representation on pension boards.

## **Require Financial Expertise on Pension Boards**

Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers. This is a weighty fiduciary responsibility that requires a thorough understanding of asset management. It would be prudent to set aside some board seats for members with professional expertise or certification in financial asset investment and to require all members to receive some basic education on their fiduciary responsibilities. Furthermore, all pension trustees should receive some relevant financial training on an annual basis.

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<sup>11</sup> For the full Civic Federation report entitled *Recommendations to Reform Public Pension Boards of Trustees in Illinois* please go to [www.civicfed.org](http://www.civicfed.org).