

Illinois Public Pension Compendium

A Five Part Series
Part One: Illinois Pension Basics

Justin Formas, CAIA

Director of Municipal Bond Credit Research

Dan Simpson

Credit Analyst

Lucas Biondi & Piotr Staron

Research Analysts

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“The General Assembly recognizes that without significant pension reform, the unfunded liability and the state's pension contribution will continue to grow and further burden the fiscal stability of both the state and its retirement system”.

(pg. 2 of the 98th Illinois General Assembly Conference Committee Report on Senate Bill 1, 12/2013)

Despite the General Assembly's admission, the State of Illinois and its retirement systems have been in decay for nearly three decades. Objectively speaking, nearly every opportunity for meaningful reform has been squandered. As a result, the retirement systems unfunded liabilities have increased markedly. To illustrate, for fiscal year end 1985, the unfunded actuarial accrued liability (UAAL) for the State's five main pension plans, essentially the portion of the liabilities of a pension plan not covered by the plan's existing assets, totaled roughly \$6.5 billion. On its face, that figure isn't unfathomable, particularly considering inflation over the last 29 years. Adjusting the \$6.5 billion UAAL for inflation, that figure grows to \$14 billion in 2013 dollars. We now can compare the State's fiscal year end 2013 UAAL of roughly \$100 billion. That equates to an increase of \$86 billion, averaging an increase of approximately \$2.98 billion annually. This is neither a surprise, nor the whole story.

The goal of this series is to identify the driving forces underlying the change in the State's unfunded liabilities. A report from the Commission on Government Forecasting and Accountability attributes the changes in the UAAL to six components: salary changes, investment returns, employer contributions, benefit increases, changes in actuarial assumptions, and other factors such as changes in retirement, disability, in-service mortality, retiree mortality, and terminations. Our focus will cover investment returns, employer contributions, changes in actuarial assumptions, and other factors. In order to provide the necessary framework for such an analysis, we will review the State's five retirement systems, the history of funding shortfalls, discuss the system's current condition, and highlight several proposed reforms.

Part one will examine, in general terms, Illinois' pension framework, governance, and actuarial valuation practices.

State of Illinois pension plans are funded through a combination of contributions by the state, employers of certain public workers, and employees whom qualify for state sponsored pensions. The majority of Illinois' pensions utilize a defined benefit (DB) plan. Under DB plans, employees contribute a fixed percentage of their salary towards a specific benefit at retirement. That specific benefit is derived from a formula which takes into consideration such variables as the employee's earnings, tenure, and age. The employee's pension contribution is collectively bargained for during periodic labor negotiations. Their respective employers and the State then contribute the remainder necessary, when combined with projected investment returns on the plan's assets, to fund benefits and expenses of the plan. The pension plans respective investment boards direct investing strategies.

The State of Illinois funds five retirement systems for public employees and retirees: the State Employees Retirement System (SERS), the Judges' Retirement System (JRS), the General Assembly Retirement System (GRS), the State Universities Retirement System (SURS), and the Teachers' Retirement System (TRS). The Teachers' Retirement System includes all public school teachers in the state except those employed by the Chicago Board of Education.

Each year the State of Illinois conducts an actuarially valuation on each of its pension plans in order to determine how much it must contribute to satisfy all current and prospective benefit liabilities. Actuarially accrued liabilities (AAL) are expressed as the present value of future benefits allocated to past service. The present value of future benefits allocated to current service is referred to as the Normal Cost.

Unfunded liabilities are those liabilities, both past and current, not covered by existing plan assets.

The unfunded liability is calculated by subtracting the actuarial value of assets (AVA) from the accrued actuarial liability (AAL) of a fund. Where AAL exceeds AVA the remaining liability is generally referred to as the Unfunded Actuarially Accrued Liability or UAAL. The funded ratio, expressed as AVA divided by AAL, measures the degree to which plan assets are sufficient to cover future benefits. The funded ratio and the UAAL are indicators of a pension system's financial health.

The employer's required contribution necessary to fund benefits over time is called the Actuarially Required Contribution or ARC. Recently the term Actuarially Determined Contribution or ADC has been used interchangeably with ARC. The ARC is equal to the sum of the employer's Normal Cost and the amount needed to amortize the UAAL over a period of no more than 30 years as promulgated by the Government Accounting Standards Board (GASB) statement 25. There are several notable differences between the State of Illinois' method of funding its pensions and the recommended approaches established by GASB.

First the State of Illinois' method of amortizing the UAAL does not conform to the provisions of GASB 25 and while the ARC might suggest that it is the mandatory amount to contribute; there are no funding requirement directives from the federal level.

For example, under the State of Illinois Pension Code, the State is required to make the Required Annual Statutory Contribution in each fiscal year. This differs from the ARC. The Required Annual Statutory Contribution is computed in accordance with the Pension Code and, more specifically, the Statutory Funding Plan. It is the Statutory Funding Plan that does not conform to the GASB pension standard, and as a result the Required Annual Statutory Contribution certified to the State by the actuary differs from the ARC.

The Statutory Funding Plan was enacted during 1995 and called for the amortizing the UAAL over a 50-year closed period beginning in Fiscal Year 1996, with the aim of reaching a funded ratio of 90% by Fiscal Year 2045. GASB 25 stipulates that amortization of the entire UAAL can only be over a 30-year open or closed amortization period. Further, the Statutory Funding Plan allowed the State to contribute less than the level percent of payroll necessary to reach the desired funding level for the first 15 years of the plan (the "ramp-up" period discussed in subsequent series). In contrast, GASB 25 does not permit a ramp-up to full contributions.

The consequence of not fully contributing the ARC is that interest accrues on the unpaid portion at the plan's expected longer term rate of return.

Another major factor distorting pension funding levels is the actuarial technique known as asset smoothing. Asset smoothing is defined as spreading gains or losses on assets over a certain period of time in order to avoid significant fluctuations in valuation. Asset smoothing typically limits its variation from the market value of assets (MVA) by no more than 20% in either direction. The figure generated through this process, AVA is then used by the State Actuary in calculating the UAAL and the ARC for employers.

The State of Illinois recognizes in the current year 20% of the investment gain or loss incurred in each of the previous 5 years. This strategy was implemented in 2009 as a means to counter balance the value of assets in the wake of the 2008 financial crisis. The strategy succeeded in downplaying a 24.9% decline of assets in terms of market value by claiming only a 1.1% drop in AVA.

The most recent reports of the Illinois' Pension Financial Condition (2013) indicate that both the MVA and AVA are currently within 4% of each other. In the past, however, the difference between the two has been greater than 22%. When cases such as this arise, the AVA used to calculate the unfunded liabilities results in a number substantially different than the actual.

As we've presented, actuarial valuation methods and pension policies can have a considerable influence over plan funding. The next part in our series will detail the State's pension policies and funding practices dating back to Fiscal Year 1985.

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