Illinois Public Pension Compendium

A Five Part Series

Part Two: Diminished or Impaired

A Historical Perspective of Illinois Pension Legislation and Funding

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"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". (Section Five: Pension & Retirement Rights – Constitution of the State of Illinois adopted at special election on December 15, 1970)

The above phrase is commonly referred to as the "Pension Protection Clause". It was part of the 1970 Illinois Constitution, ratified on this day 44-years ago, December 15th, 1970. It became effective July 1st the following year.

Prior to the 1970 Constitution enactment, participation in an Illinois public employee pension plan was either mandatory or optional.

If participation was mandatory, any amendment could retroactively affect pension rights, assuming the participant had not yet retired, or passed away. *See Keegan v. Board of Trustees (1952), Jenner & Block Pension Law Handbook.*

If participation in a pension plan was optional, then the pension was an enforceable contract. *See Bardens v. Board of Trustees of the Judges Retirement System* (JRS) *(1961), See Keegan v. Board of Trustees (1952), Jenner & Block Pension Law Handbook.*

In the Bardens case, the Illinois Supreme Court found that since participation in the JRS pension plan was optional, participants in the plan had a contractual right to a pension calculated under the statue that existed under the original employment agreement.

The Illinois Supreme Court's decision to define pension benefits within the constructs of enforceable contracts strengthens the relationship to the application of contract law, which generally stipulates that upon vesting, benefits are essentially unalterable.

This is an important distinction, particularly for those public employees participating in mandatory pension plans. A distinction magnified by the poor funding conditions of the pension plans leading up to the 1970 Constitutional Convention.

As a reference point, in a report from the Illinois Public Employees' Pension Laws Commission of 1969, the total unfunded accrued liabilities for public employee pension plans in Illinois was roughly $2.5 billion with a ratio of net assets to total accrued liabilities of 45%. A funded ratio not too unfamiliar to public employees participating in Illinois' pension plans today. (See Chart in Appendix A)

Given the funding circumstances in 1968, it's evident why public employees participating in mandatory pension plans were wary of losing their pension benefits. The pension system was inadequately funded and their entitlements could be changed under existing legislation.

Public employees lobbied lawmakers to eliminate the distinction between mandatory and optional participation. The legislature obliged reinforcing the Pension Protection Clause by adding the requirement that the benefit of the employment relationship not be "diminished or impaired".

Since the Pension Protection Clause was adopted, several court rulings have upheld that reductions in pension benefits are unconstitutional. Most recently, and in response to a December 2013 law aimed at "fixing" Illinois' pension system, Sangamon County Circuit Court Judge John Belz ruled the law "unconstitutional and void in its entirety".

"The state of Illinois made a constitutionally protected promise to its employees concerning their pension benefits," Belz wrote in his decision. "Under established and uncontroverted Illinois law, the state of Illinois cannot break this promise." *See Pension Litigation Order filed 11/21/2014 Sangamon County Circuit Clerk*.

The Illinois Attorney General has appealed the decision and the case is pending in front of the Illinois Supreme Court.

The Pension Protection Clause is highlighted because efforts to reform the pension system will be constrained by its interpretation. The reality is, the Illinois pension system has faced persistent challenges for nearly a century.

To illustrate, an examination of historical records uncovered a statement from then Governor Frank O. Lowden. In his message to the 51st General Assembly on January 8th, 1919, regarding the findings and recommendations of the Illinois Pension Laws Commission (IPLC):

> "This commission has made a very exhaustive study of the subject. I will submit its full report to you later. ***<u>Among other things however, that commission had found that nearly all, if not all, of the several pension funds created by the different municipalities of the State as well as by the State itself, are hopelessly insolvent.</u>*** These funds were established with wholly inadequate provisions for their future. The contributions made by the employees and by the municipalities or State were altogether insufficient to meet the obligations which the municipalities and state have incurred, morally at least."

In the report that follows Governor Lowden's statement, there is an analysis regarding the State's pension laws. The analysis reasoned that pension benefits were simply gratuities. Additionally, the analysis revealed pension funds were not held in trusts and therefore could conceivably be redirected for other purposes. Concerns over the State and municipalities potentially misappropriating pension funds led lawmakers to include an amendment to the 1922 Constitutional Convention that would limit such actions. Ultimately, the amendment was not adopted, but the legal analysis suggests exploration of the underlying themes of underfunding and enforceable contracts.

On the subject of pension underfunding, the IPLC report from 1916, found that the pension provisions for the City of Chicago's police, firefighters, and teachers fund's current employees and their beneficiaries were deficient by an estimated $48 million (About $1.0 billion in today's dollars). The State's Municipal Employees Pension Fund was deficient by roughly $7 million and the State's Teachers Pension Fund was deficient by an estimated 7% to 12% of annual salary payments of $11 million.

Three decades later we find the State's pension situation in familiar form.

In 1945 the General Assembly created a successor to the IPLC, the Illinois Public Employees' Pension Laws Commission (IPEPLC). It had a similar directive as the IPLC and issued biennial reports on the status of the State's pension systems from 1947 to 1969. In the IPEPLC's first report, it described the concerns surrounding the viability of the State's pension system as follows:

"This commission is deeply concerned in respect to the character of many existing pension laws in this date and the status of the funds operating thereunder. That concern related principally to the following conditions:

> *(1)Tremendous, ever increasing and disproportionate liabilities being imposed upon present and future generations of taxpayers by reason of the absence of a consistent or guiding pension policy, (2) The steady weakening of existing public employee pension funds occasioned by frequent liberalizing amendments unsupported by necessary revenues, (3)The tendency of some pension fund representative's spokesmen for employee organizations and employees to view the pension problem in terms of short sighted self-interest and their disinclination to adopt a reasonable and realistic approach to the overall pension problem, (4)The failure of public authorities to give to the pension problem a measure of official interest commensurate with its importance in terms of governmental fiscal liabilities, (5)The lack of awareness of the serious implications of the pension problem on the part of civic groups interested in public administration, (6)The continued existence of a large number of small membership funds which are difficult of administration and control and (7)The absence of pension coverage for a great many public employees"*

Statements that if otherwise unattributed could have been articulated by politicians today.

The initial IPEPLC report found that the State's combined public employee pension systems had a total accrued liability of $513 million against net present assets of $153 million, leaving $359 million in liabilities unfunded. The pension systems had a funded ratio of just 29.9%. Not to be overlooked, the prevailing economic conditions from the prior decade (The Great Depression (1929-1940), World War II (1939-1945)) could have had a material impact on this figure.

The IPEPLC reports from 1947 to 1969 are valuable because they suggest tangible, albeit incremental, efforts to improve the pension systems funding.

For example, in the chart in Appendix A, eight of the 12 periods showed net present asset growth, out pacing liability growth. The funded ratio improved from 29.9% to 45.3% from 1946 to 1968. All things considered a positive move toward pension fund stability.

This brings us back to where we began our piece, the 1970 Illinois Constitution.

After the Pension Protection Clause's adoption, the IPEPLC continued to address the status of the pension systems until it was ended in 1984 and its functions transferred to the Illinois Economic and Fiscal Commission (IEFC).

During the 1970s and the 1980s, the IEFC continued to encourage aligning pension obligations with actuarial principles. The IEFC recommended paying the "normal cost plus interest" on unfunded liabilities.

This pension contribution funding approach covers the current cost of benefits accrued by employees each year as well as the cost associated with the interest due on unfunded liabilities. This approach may not provide a permanent funding solution as it does not address the principal unfunded liability. However, it does ensure that the principal balance of the unfunded liability remain a fixed amount which could, over time, decrease as a percentage relative to payroll or total liabilities.

In 1979, the Governor's office commissioned a report that concluded Illinois' pension obligations had "reached crisis proportions" because funding benefit payouts had "increased dramatically in recent years." *See Illinois Public Employee Relations Report, Volume 31 Issue 3* According to reports from the Bureau of Budget and the State Comptroller referenced in the Illinois Issues magazine, spending on the State's five pension systems rose from $246 million in FY1975 to $366 million in FY1979. Unfunded liabilities grew from approximately $3.0 billion to $4.2 billion over the same time period. The Governor's Office report also noted that "Moody's and Standard & Poor's have expressed concern regarding the continuing increase of unfunded pension liabilities in Illinois," and that Illinois would jeopardize its "AAA bond rating" if "the unfunded liability is not stabilized".

From FY1973 to FY1981, the State's pension contribution policy was to appropriate the amount paid out to retirees annually. This was referred to as the "payout" policy or the "100% payout policy" because the goal was to equate the State's contribution to the amount needed to fund pensions annually. This policy also allowed the State to reinvest employee contributions in order to generate additional investment income and offset increases in the UAAL. Higher than expected investment returns helped increase the funding ratio of these systems from roughly 41% at the time of 1970 Constitutional Convention to 48% in 1979 according to historical Bureau of Budget and State Comptroller reports from Illinois Issues magazine.

Subsequently and in order to provide the State with improved budgetary flexibility, the Governor proposed adjusting the "100% payout" policy in 1981. In its place, the State would contribute 70% in 1982 and 60% in 1983. By 1988, the contribution had been reduced to 44% of the estimated payout to retirees.

Moreover, while modifying the "payout" policy in 1982, the legislature approved a bill expanding the investable universe of securities for pension funds. As a result, the legislation shifted a majority of the pension funding burden to investment returns. According to Bureau of Budget reports, investment returns as a component of income for the State's five main pension systems increased from $392 million in 1981 to $1.5 billion in 1986. The State contribution component declined 33% in 1982, and 1% again in 1983 before gradually increasing to $431 million in FY1986. The aggregate funded ratio improved from 50.2% to 57.3% over that time.

Despite the modest improvement, the IEFC continued to recommend at minimum the "normal cost plus interest" funding approach because ultimately the "payout" policy failed to address the principal and interest components of the unfunded liability.

In between fiscal years 1989 and 1995, the State's contribution to the JURS, SERS, and GARS pensions where short by $1.0 billion. In testimony before Congress in 1991, Comptroller Dawn Clark Netsch stated that Illinois' pension problem was "underfunding" and that "underappropriated pension contributions are like unpaid credit card bills" that eventually, must be paid. To highlight this point, Netsch noted how the legislature diverted $21 million from moneys otherwise automatically transferred into the State's pension system to the State's General Revenue Fund for expenditure on other State programs.

In June 1994, the General Assembly and the Governor reached an agreement on a new pension funding plan modeled after the Governor's 1994 proposal. The 1995 funding plan was later signed into law as Public Act 88-0593. The legislation created a 50-year plan to achieve 90% funding of the State's five pension systems by fiscal year 2045. The legislation included a 15-year ramp-up period of increasing pension contributions so the State could acclimate to the increased financial commitment. The State's contribution would incrementally increase between FY1995 and FY2010. At the end of that period in FY2010, the State's contributions would remain at a level percentage of payrolls for thirty-five years until reaching 90% funding in fiscal year 2045.

Conceptually, the purpose of the law was to gradually increase contributions over time, while creating a timeframe to address the "normal cost plus interest". When the plan began in 1995, the State's pension systems were underfunded with almost $20 billion in unfunded liabilities and a funding ratio of 53%.

The pension system improved considerably between FY1997 and FY2000, due in large to excess investment returns stemming from the dot com era.

The improvement however would be short-lived. Between FY1995 and FY2003 the State increased pension benefits by approximately $5.8 billion. Nearly half of which was the result of an early retirement incentive (ERI) offered to public employees in 2003.

In 2002 the State Comptroller estimated 7,300 employees would opt-in to the 2003 ERI generating a savings of $115 million in payroll related costs in that current fiscal year. The Comptroller's Office estimated the ERI would generate $2.85 billion in payroll related savings over the next nine years. A portion of the payroll savings would then go to defray over a ten year period the $622 million in additional unfunded liabilities created by the ERI.

Instead, approximately 11,000 employees ended up taking advantage of the ERI. This resulted in an increase in the unfunded liability of $2.37 billion according to the Commission on Government Forecasting and Accountability report on the Costs and Savings of the State Employee's ERI Program.

Further pressuring matters, the investment returns that had previously provided excess revenues withered as the equity market collapsed from the dot com bust. The State's aggregate funded ratio declined to 48.8% in FY2003.

Unable to balance the budget and amortize the considerable increase in unfunded liabilities from the ERI, the State folded the ERI liability into the 50-year ramp-up plan.

In June 2003, the State authorized the issuance of $10 billion of general obligation pension bonds for the purpose of reimbursing the State's General Revenue Fund for $300 million of the Required Annual Statutory Contribution made for FY2003, funding $1.86 billion for the FY2004 Statutory Contribution, and contributing $7.3 billion to fund a portion of the UAAL in FY2004. The aggregate funded ratio for the State's pension plans improves to 60.9% at the end of FY2004.

We will discuss the relationship between the interest rate on the State's pension bonds and the assumed and actual returns of the pension plan's investments impacts the UAAL in part three of our series.

The State passed several pension reform bills in 2006. Most notably, the legislature enacted a two-year pension payment "holiday". Under the provisions of the 50-year ramp-up plan, the State would have been required to contribute $2.12 billion in FY2006 and $2.51 billion in FY2007. The pension "holiday" reduced these contributions to $938 million and $1.37 billion, respectively, which represented reductions of 55.7% and 45.3%, respectively. This resulted in an increase in the UAAL as well as delaying payment on the already deferred portion of the State's contributions.

The State made the full Required Annual Statutory Contributions for FY2008 and FY2009, but the economic downturn had a sizeable impact on investment return and asset balances. The State's funded ratio declined to 38.3% by the end of FY2010.

On January 7, 2010, the State issued $3.47 billion of general obligation pension funding bonds to fund a portion of the FY2010 Required Annual Statutory Contribution. The following year, the State issued $3.7 billion in general obligation pension funding bonds to fund a portion of the Required Annual Statutory Contribution for FY2011.

The State made its Statutorily Required Contribution in FY2012 and FY2013. As of the end of FY2013, the State of Illinois Pension Systems had an aggregate UAAL of approximately $100.5 billion on an actuarial basis resulting in a funded ratio of 39.3%.

Since FY1996, the unfunded portion of the State's pension obligation has grown by $79.6 billion. The State's failure to make the full actuarially required contribution in many prior years accounts for a substantial portion of that increase. However, other factors play an integral role in changes to the UAAL. We will explore those factors in part three of our series.

Appendix A

State of Illinois Pension System Funding IPEPLC Reports 1946 to 1969

Year	Net Present Assets	Total Accrued Liabilities	Unfunded Accrued Liabilities	Ratio Assets to Liabilities
1946	$153,520,000	$513,008,300	$359,488,300	29.9%
1948	$188,536,043	$610,630,491	$422,094,448	30.9%
1950	$249,635,895	$730,950,204	$481,314,309	34.2%
1952	$323,347,366	$965,211,571	$641,864,205	33.5%
1954	$418,515,689	$1,182,462,114	$763,946,425	35.4%
1956	$544,694,236	$1,558,088,292	$1,013,394,056	35.0%
1958	$675,856,008	$1,860,862,108	$1,185,006,100	36.3%
1960	$863,642,807	$2,224,171,213	$1,360,528,406	38.8%
1962	$1,095,112,990	$2,610,000,312	$1,514,887,322	42.0%
1964	$1,354,672,141	$3,070,066,047	$1,715,393,906	44.1%
1966	$1,646,110,392	$3,594,718,075	$1,948,607,683	45.8%
1968	$2,024,157,656	$4,472,164,005	$2,448,006,349	45.3%

Source: Illinois Public Employee Pension Laws Commission Report 1969, page 34, table 5

Illinois Combined Pension Systems 1975 to 1986

	($ in millions)				Income Source ($ in millions)		
FY	Asset Balances	Liabilities	Unfunded Obligations	Assets Liabilities	Member Contributions	State Contributions	Investment Income
1975	$2,318	$5,391	-$3,073	43.0%			
1976	$2,651	$5,999	-$3,348	44.2%			
1977	$3,011	$6,675	-$3,664	45.1%			
1978	$3,430	$7,238	-$3,808	47.4%			
1979	$3,892	$8,087	-$4,195	48.1%			
1980	$4,494	$8,969	-$4,475	50.1%			
1981	$5,190	$10,330	-$5,140	50.2%	$310.2	$406.3	$392.7
1982	$5,749	$11,686	-$5,937	49.2%	$330.1	$271.8	$417.7
1983	$6,334	$12,882	-$6,548	49.2%	$345.4	$268.7	$464.9
1984	$6,956	$14,283	-$7,327	48.7%	$358.8	$343.9	$468.1
1985	$7,856	$15,143	-$7,287	51.9%	$387.5	$389.9	$720.7
1986	$9,551	$16,713	-$7,162	57.1%	$422.6	$431.8	$1,506.1
1987						$452.0	
1988						$393.0	
1989						$417.0	
1990						$478.0	
1991						$476.0	
1992						$445.0	

Souce Bureau of Budget, State Comptroller Office, Illinois Economic and Fiscal Commission, Illinois Issues Magazine

State of Illinois Retirement Systems (Combined TRS, SERS, SURS, JRS, GARS)
Retirement System Funding Table
($ Millions)

FY	Actuarial Valued Assets	Actuarial Valued Liabilities	Unfunded Liabilities	Funded Ratio	Amounts Contributed	Required Contribution	ARC Percentage	"+/-"
1985	$7,856	$14,930	-$7,074	52.6%				
1986	$9,551	$16,417	-$6,866	58.2%				
1987	$10,956	$17,914	-$6,958	61.2%				
1988	$11,940	$19,604	-$7,664	60.9%				
1989	$13,030	$21,264	-$8,234	61.3%				
1990	$14,375	$24,883	-$10,508	57.8%				
1991	$15,467	$27,208	-$11,741	56.8%				
1992	$17,217	$30,132	-$12,915	57.1%				
1993	$18,805	$32,929	-$14,124	57.1%				
1994	$20,409	$37,424	-$17,015	54.5%				
1995	$21,494	$40,991	-$19,497	52.4%				
1996	$23,584	$44,392	-$20,808	53.1%				
1997	$32,188	$45,900	-$13,712	70.1%				
1998	$37,241	$51,563	-$14,322	72.2%				
1999	$41,442	$56,787	-$15,345	73.0%				
2000	$45,949	$61,518	-$15,569	74.7%				
2001	$42,789	$67,768	-$24,979	63.1%				
2002	$40,252	$75,198	-$34,946	53.5%				
2003	$40,925	$83,905	-$42,980	48.8%	$1,685	$2,535	66.5%	-$850
2004	$54,769	$89,912	-$35,143	60.9%	$9,176	$2,656	345.5%	**$6,520**
2005	$58,577	$97,179	-$38,602	60.3%	$1,735	$3,084	56.3%	-$1,349
2006	$62,341	$103,073	-$40,732	60.5%	$1,022	$3,085	33.1%	-$2,063
2007	$70,731	$112,908	-$42,177	62.6%	$1,479	$3,665	40.4%	-$2,186
2008	$64,700	$119,084	-$54,384	54.3%	$2,145	$3,729	57.5%	-$1,584
2009	$48,542	$126,435	-$77,893	38.4%	$2,891	$4,076	70.9%	-$1,185
2010	$53,225	$138,794	-$85,569	38.3%	$4,130	$4,786	86.3%	-$656
2011	$63,382	$146,460	-$83,078	43.3%	$4,298	$5,906	72.8%	-$1,608
2012	$61,813	$158,611	-$96,798	39.0%	$5,012	$6,609	75.8%	-$1,597
2013	$64,957	$165,458	-$100,501	39.3%	5893	7015	84.0%	-$1,122
2014***	$71,011	$172,236	-$101,225	41.2%				
2015***	$76,606	$179,154	-$102,548	42.8%				
2016***	$80,641	$186,150	-$105,509	43.3%				

Source: Commisson on Government Forecasting and Accountability, State of Illinois CAFRs 1990 to 2013, State of Illinois Official Statements

***Projected

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