THE GOVERNOR'S COMMISSION ON STATE PENSIONS:

THE INTERIM REPORT ON NEAR-TERM FUNDING

I. COMMISSION MEMBERSHIP AND MANDATE

The Members

The members of the Governor's Commission on State Pensions are:

- James Annable, who served as Chair through this Interim Report, is Managing Partner at the FRG Company, Secretary of the Federal Advisory Council of the Board of Governors of the Federal Reserve System, and formerly was Chief Economist at the First National Bank of Chicago, First Chicago NBD, and Bank One Corporation;
- Representative Mark Beaubien has represented Illinois' 52nd District since 1997;
- Roland Burris is the Manager and CEO of Burris & Lebed Consulting, LLC and has held numerous political offices including Illinois Attorney General;
- Andy Davis is Chairman and CEO of Rock Island Company of Chicago, and the Vice-Chairman of the Chicago Stock Exchange;
- Ronald Denard is Vice President of Finance and Administration at SoftSheen-Carson, a L'OREAL USA Company;
- Representative Bob Molaro represents Illinois' 21st District and previously served nine years in the State Senate;
- Laurence Msall is President of The Civic Federation;
- Ronald Powell is President of United Food and Commercial Workers #881 and Vice President of United Food and Commercial Workers International;

- Gerald Roper is President and Chief Executive Officer of the Chicagoland Chamber of Commerce;
- Senator Jeff Schoenberg represents Illinois' 9th District and previously served six terms as a State Representative;
- Paula Wolff is Senior Executive at Chicago Metropolis 2020; and

The Commission met six times between April 16 and May 24, 2004.[1]

The Mandate

Governor Blagojevich's mandate to the Commission is:

> To review the condition of the Illinois State Pensions, in the context of their funding requirements, their employee benefit and contribution structures, their administration, and their effect on Illinois fiscal-policy choices and economic performance, and to make recommendations to improve the pension system.

This interim report focuses on near-term State funding of pension liabilities. The Commissioners unanimously agreed that an adequate analysis of the important public policy issue of unfunded State pension obligations must centrally include consideration of benefit and contribution changes as well as funding strategies. However, in the interest of producing timely recommendations on pending funding issues and given the Commission's desire not to interfere with on-going collective bargaining negotiations, it was decided to issue an interim report on near-term funding strategy.

After the current round of bargaining is complete, the Commission will continue its work, shifting attention to the larger, more fundamental issues and problems, notably including employee benefits and contributions, associated with the State's unfunded pension obligation.

The Structure of the Report

The next five sections of this report summarize the fact-finding phase of the Commission's work on funding. Section II describes the near-term problem in the context of the legislation governing State contributions to the pension funds. Section III brings the Illinois economy into the analysis, outlining how it influences, and is influenced by, State funding choices. The fundamental causes of the current problem are then identified in Section IV. Section V provides the principles of sound fiscal policymaking that were identified by the Commission and adhered to in formulating the conclusions. Section VI reviews the near-term funding options. The Commission's near-term funding choices are presented in the seventh and final section.

II. THE NEAR-TERM FUNDING PROBLEM

The retirement system of Illinois consists of five distinct plans, three of which have produced almost all of the State pension liabilities. As of June 30, 2003, the Teachers plan (TRS) accounted for $46.9 billion in estimated liabilities ($23.8 billion of which was unfunded); the Universities (SURS) $18.0 billion ($8.3 billion of which was unfunded); and the State Employees (SERS), $17.6 billion ($10.1 billion of which was unfunded). The other two plans, the General Assembly (GARS), $0.2 billion ($0.1 billion of which was unfunded) and the Judges (JRS) $1.1 billion ($0.7 billion of which was unfunded), have generated relatively small obligations. State

funding requirements are governed by the 1995 funding law and the 2002 Early Retirement Incentive (ERI) program.

The 1995 Funding Law

Public Act 88-593 (the 1995 funding law) made a number of changes to public employee pensions, the most significant of which was the adoption of a funding plan. The General Assembly established a funding ratio of 90% for the State funded retirement systems, to be achieved by 2045. From FY2011 through FY2045, the required contribution would be the level percent of payroll required to reach 90% funding by FY2045. For FY1996 through FY2010, the contribution percent would increase in equal increments to the rate required in FY2011.

The ERI Program

The Early Retirement Incentive (ERI) program, implemented in 2002, mandates a separate funding schedule from the 1995 plan. The cost of the program is amortized over ten years and is applicable predominately to the State Employees Retirement System (SERS).

The Commission reviewed the current state of this program. Its cost is most recently estimated to be nearly $2.5 billion, compared to the original estimate of $622 million. The extraordinary increase has significantly complicated near-term funding choices and resulted from:

- Increased pensions to select employees ($457 million);[2]
- Additional retirees motivated by additional benefits ($1.043 billion);[3] and
- Actuarial assumption errors ($331 million).[4]

Sizing the Near-Term Funding Problem

The 1995 funding plan. The key data on the history and near-term prospects (in italics) for State funding of its pension liability under the 1995 law are as follows:

TABLE 1. Actual and Projected Funding Required by 1995 Plan

Fiscal Year	**Funded Ratio**[5]	**Percent of Compensation**	**Pension Funding** (in millions)[6]
1994	55%	5.9%	$540
1995	52%	5.6%	545
1996	53%	6.3%	638
1997	70%	7.2%	742
1998	72%	8.4%	914
1999	73%	10.3%	1,155
2000	75%	10.8%	1,261
2001	63%	11.4%	1,385
2002	54%	11.7%	1,512
2003 (w/o POB)[7]	49%	12.1%	1,673
2004	57%	13.0%	1,790
2005	*57%*	*13.7%*	*2,109*
2006	*57%*	*15.8%*	*2,418*
2007	*57%*	*17.7%*	*2,818*
2008	*58%*	*18.7%*	*3,118*
2009	*58%*	*20.7%*	*3,518*
2010	*59%*	*21.7%*	*3,918*

The ERI program. The ERI funding was $71 million in FY2004 – a contribution level based on the original, grossly underestimated cost projections. With the more accurate costing of the enhanced benefits included in the early-retirement program, the required annual contribution is now $382 million from FY2005 through FY2013.

Near-term annual funding requirements. Combining the requirements of the 1995 schedule and the revised ERI costs, the near-term State pension funding requirements are nearly $2.5 billion in FY2005 and $2.8 billion in FY2006. High and increasing annual State pension contributions are substantially affecting fiscal policy priorities and the capacity of the State to deal effectively with other problems and to exploit available opportunities.

III. FISCAL POLICY CHOICES AND THE ILLINOIS ECONOMY

The Commission agreed on the necessity to account for the state of the economy in rational funding choices.

The Illinois Economy

Diane Swonk, Chief Economist and Director of Economics for the Bank One Corporation, briefed the Commission about the Illinois economy, concluding the following:

- The State economy tends to move with, but is more cyclical than, the national economy. It tends to lead the nation into recessions and lag into recoveries.
- Economic growth, especially employment growth, is the single best predictor of State revenue growth.
- The national economy is experiencing a cyclical rebound, which is also occurring with a lag in the State economy and with a longer lag in State revenues. Her forecast of Illinois general revenues showed that they, while improving, would still remain some 6% below their 1990-2003 trend in FY2006.

Economic Principles

Swonk then identified two fundamental economic principles that are relevant to State fiscal policymaking:

- *Cyclical-Adjustment Principle*: Illinois has a particularly cyclical economy. State fiscal policy choices are affected by, and should be adjusted for, the stage of the business cycle.
- *Dynamic-Scoring Principle*: Capital and population are mobile, seeking their most advantageous location, especially within an area with a common currency. Illinois, as a result, is in constant competition with other States for jobs and economic growth. State fiscal-policy choices must take into account the feedback between its tax and spending decisions and economic growth.

In closing, she presented a heuristic chart that presents the two economic principles in the context of funding the State pension liability. (See Chart 1.) She noted that, in application, the economic principles and near-term political incentives often conflict.

IV. CAUSES OF THE FUNDING PROBLEM

The current funding problem is largely rooted in actions taken when Illinois economic growth and revenues as well as equity prices were cyclically robust: the consistent record of substantial under-funding of the several pension funds relative to actuarial requirements as well as a tendency to increase benefits when funded ratios were (temporarily) high.

Before 1995 funding legislation, funding was well short of the actuarial requirements. After implement-ation of the 1995 law, annual funding decisions adhered to the fixed, ramped-up funding schedule, ignoring the cyclical opportunity (provided by the long 1990s economic boom) to contribute in line with or, better yet, exceed actuarial requirements.

The fixed, ramped-up contribution schedule in the 1995 law has produced perverse incentives, resulting in the violation of both fundamental principles linking Illinois economic performance and fiscal policy choices identified by the Commission. State pensions were under-funded in an exceptionally strong economic environment, while benefits – most notably, the costly Early Retirement Incentive program – were increased. The violation of the two fiscal-policy principles implied substantial adverse pressure on the State's capacity to fund pension obligations when the economy weakened. A downturn in the Illinois economy and revenues has, indeed, occurred; and the current pension-funding problem has been made exceptionally difficult by the long history of poor contribution and benefit decisions.

V. PRINCIPLES OF SOUND FISCAL POLICYMAKING

The Commission emphasized that pension-funding decisions should be consistent with fundamental values of the people of Illinois and the capacity of the State economy to prosper, adopting the following principles:

- The State must fully honor its pension obligations.
- Pension-funding decisions are affected by, and should be adjusted for, the stage of the business cycle.
- Pension-funding choices must take into account the feedback between those decisions and Illinois economic growth.
- Pension-funding choices should not damage State creditworthiness and its capacity to raise funds in capital markets.

The implications of those principles were discussed by the Commission, with particular attention to two points. First, it must be clearly understood that the State's pension liability is debt that does not differ from any financial debt, including bonded debt. Both types of obligation must be met. Second, the concept that pension-funding schedules should be amended to include a trigger mechanism to permit under-funding when State revenue growth is depressed by cyclical weakness and mandate over-funding during periods of cyclical strength was unanimously endorsed. Triggers are consistent with sound fiscal policy and help underscore the true problem in the current funding situation. The difficulty is rooted more in the inadequate funding actions during the 1990s economic boom, than in fiscal-policy choices in the recent recession. Triggers would give teeth to the principle that pensions should be over-funded in periods of cyclically robust revenue growth.

VI. NEAR-TERM FUNDING OPTIONS

Make Required Payments Out of State General Revenue

The first option is to pay all the pension contributions required by the 1995 funding law and the newly expensive ERI program out of State general revenues.

An implication of using this approach is that other spending must be curtailed or revenues (taxes/fees) increased. This option is made especially difficult in the current environment by the cyclical phase of Illinois revenue growth, which is likely to remain relatively depressed through FY2006. Given that the fixed funding schedules of the 1995 law and the ERI legislation violate the cyclical-adjustment principle and provide incentives to violate the dynamic scoring principle, it was suggested that the funding laws should be amended to include a cyclical trigger mechanism, allowing reduced contributions (relative to actuarial requirements) when State

revenues are cyclically depressed and mandating increased contributions when revenues are cyclically enhanced.

Make Required Payment via New Borrowings

The second option is to pay part of the required contribution with new borrowings. This implies another round of longer-term financing of the unfunded pension obligation.

Larry Morris, Senior Managing Director of Mesirow Financial, who is a specialist in public finance, discussed three interrelated borrowing-related questions that had been raised by Commissioners:

- How did the capital markets receive the 2003 $10 billion Pension Obligation Bonds?
- What are current market conditions?
- What is the market capacity for Illinois longer-term debt?

The 2003 bond program was exceptionally well received, selling out in the first day at a rate well below that planned. There was strong international demand, especially from Europe; and Morris estimated that that buyers at the offer rate exceeded the available supply of bonds by at least 2 to 1. Moreover, there is little evidence of "churning" (or quick reselling) in the issue; original buyers appear to be holding the bonds.

Since the issuance of the Pension Bonds, the major change in market conditions is the increase in market interest rates, reflecting spreading investor belief that the national economic recovery is well rooted and will continue. (It also reflects the extraordinary good timing of the POB program, issued within days of a fifty-year low in market bond rates.) The benchmark 10-year Treasury note rate in mid-May 2004 was near 4.8%, about 1-1/4 percentage points above its rate when the POB program was executed.

Morris argued that the capacity of the market to absorb additional Illinois debt depends on how the funds are to be used:

- If the funds were invested in long-term assets (such as pension funds with reasonable expectations that returns would exceed wage growth), investors would expect Illinois taxpayer liability to be reduced without harming prospects for State economic growth. In this case, capital markets would be receptive to new borrowings.
- If the funds replaced another existing State financial liability, investors would perceive no net change in Illinois debt and market capacity would be little affected.
- If borrowings chronically replaced State funding of the pension obligations, especially in periods of cyclically strong Illinois economic and revenue growth, investors and rating agencies would no doubt become wary – forcing the State to pay relatively high interest rates.

In summary, the advantages of issuing another round of pension obligations bonds include: (a) the market, although rates have been rising, is still relatively cheap compared both to historical costs and to expected returns on longer-term assets; (b) the principle of under-funding in periods of cyclically depressed State revenue growth would not be violated; and (c) the competitive position of Illinois in the on-going contest for jobs, business capital and population would not be harmed. The principal disadvantage is that, if a pattern of borrowing to replace annual State contributions to the pension funds is sustained into a more cyclically robust period, Illinois creditworthiness would be damaged.

<u>Make Required Payments out of 2003 POB Program Over-Funding of the Pension Funds</u>

The Commission reviewed the POB program, executed on June 12, 2003, in some detail. It was designed based on two market assumptions. First, the cost of selling the bonds would be 5.8%.

Second, the yield on the assets in which the bond proceeds would be invested would average 8%. The difference, if realized, will reduce the pension liability burden on Illinois tax-payers.

The market rate assumption used in planning the bond sale turned out to be especially conservative. The $10 billion offering sold out at a price of 5.05 % – an extraordinarily low long-term rate. The result was that POB proceeds over-funded the pension funds, relative to the original plan authorizing the sale, by $859 million. That over-funding could be used to satisfy, in part, near-term State pension contributions, especially given that State revenues are currently cyclically depressed.

Change the Funding Mechanism for the Early Retirement Incentive (ERI) Program

Two options were presented to change the fixed-contribution amortization schedule mandated in the 2002 ERI program: (a) extend the amortization period and (b) consolidate the ERI contributions into the 1995 funding plan. It was also suggested that longer-term debt, along the lines of the Pension Obligation Bonds, could be issued and dedicated to funding the ERI program. For the Commission's purposes, however, that suggestion is equivalent to the longer-term borrowing option outlined earlier and will not be reprised here.

Extended amortization. The level annual contribution requirements for the ERI program under alternative amortization schedules are:

- Ten years -- $345 million;[8]
- Twenty years -- $239 million;
- Thirty years -- $210 million; and
- Fifty years -- $195 million.

Fold into the 1995 funding plan. Putting the ERI funding on the same schedule as other pension obligations would produce a significant change in near-term State contributions to the SERS pension fund:

Year	Current ERI Contribution	Contribution if under the 1995 Plan	Change
FY2005	$380 million	$23 million	-$357 million
FY2006	$380 million	$48 million	-$332 million

The cost of such a change, of course, is an increase in annual contributions later in the 1995 funding-plan schedule. The State contribution rate (as a share of projected payroll) would rise from 17% to 20.9% in FY2020 – a differential that is then roughly sustained through fiscal year 2045:

TABLE 2. Effect of Folding the ERI Contributions into the 1995 Funding Plan
State Contribution Rate*

Fiscal Year	**Current Law**	**ERI Included in 1995 Plan**
2005	20.9%	10.8%
2006	21.7%	12.8%
2007	22.5%	14.8%
2008	23.1%	16.5%
2009	23.9%	18.5%
2010	24.8%	20.5%
2011	24.5%	20.6%
2012	24.1%	20.5%
2013	23.8%	20.7%
2014	16.9%	20.8%
2020	17.0%	20.9%
2030	16.8%	20.7%
2045	17.0%	20.9%

*The ratio of required State pension contributions to the projected payroll of covered employees. The data refer to contributions to the SERS pension fund, which generate $380 million out of the total $382 million annual required ERI contribution.

VII. COMMISSION CONCLUSIONS

The proposed FY2005 budget funds $2 billion of the $2.5 billion mandated State payment to the pension funds out of general revenue. To fund the remaining $0.5 billion FY2005 obligation, ten out of the eleven total members of the Commission identified four options that can be used singly or in combination:

- Use part of the better-than-expected present-value savings that resulted from the extraordinarily beneficial market interest rates when the 2003 Pension Obligation Bonds were sold.
- Execute another Pension Obligation Bond program, to take advantage of market interest rates that are still significantly below expected longer-term asset yields.
- Reschedule the funding mandated in the Early Retirement Incentive program to be more in line with other State pension funding.
- Fund the remaining contribution out of general revenues.

Laurence Msall dissented from this report. See Attachment A.

FOOTNOTES

[1] The Commission has received invaluable help in its deliberations from Deloitte Consulting LLP and Mercer Human Resource Consulting. Both had been engaged by The Office of Management and Budget (OMB) to review the Illinois State retirement system. John Frigo of OMB and Ronald Picur, the fiscal policy advisor to OMB, organized their findings into useful presentations to the Commission. Viktoria Wang of the FRG Company helped organize the hearings.

[2] The detailed breakdown is: (a) enhancement of the alternate formula not included in the original actuarial estimate ($159 million), (b) change in the eligible pool as older employees delayed retirement waiting for the long-anticipated early retirement window ($183 million), and the waiver of the early retirement penalty, i.e., the reduction of benefit by ½% per month the new retiree is under age ($115 million).

[3] The detailed breakdown is: (a) additional retirements of 50-55 year-olds eligible for unreduced retirement benefits with a waiver of early retirement reduction ($642 million), and (b) additional retirements of employees under 50 years old, permitted to quit, not retire ($401 million).

[4] The detailed breakdown is: (a) errors in the salary and service assumptions ($195 million) and (b) unexplained actuarial variance ($136 million).

[5] The funded ratio is a point in time comparison between fund asset value and actuarial accrued liability.

[6] Includes both the certified contributions and debt service on the Pension Obligation Bonds. Debt service is $0.5 billion annually starting in 2005.

[7] In July 2003, the State issued pension obligation bonds, contributing $7.3 billion to the funds and increasing the funded ratio to 57%.

[8] The difference between the level annual 10-year contribution requirement of $345 million and the actual requirement in FY2005 of $382 million is caused by the mistakenly low first-year payment of $71 million.

ATTACHMENT A.

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Barbara Stewart*
Vice Chairman
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May 25, 2004

Mr. James Annable
Federal Advisory Council
Office of the Secretary
c/o Bank One
1 Bank One Plaza Suite 2530
Chicago, IL 60670

Dear Chairman Annable:

The Civic Federation commends you and the other members of the Governor's Commission on State Pensions for their hard work on the difficult issue of state pension funding. We support many of the principles of sound fiscal policymaking outlined in the Commission's Interim Report on Near-Term Funding. However, as President of The Civic Federation, I am unable to support the funding options recommended in the Interim Report.

The Civic Federation supported Governor Blagojevich's $10 billion Pension Obligation Bond issue in 2003 because its intent was to correct for the State's past underfunding of its pension liabilities. Continuing to defer payment of pension obligations or borrowing again to meet those obligations would not be sound fiscal policy. The Federation has repeatedly conveyed our concerns regarding the Governor's FY2005 Budget proposal to reduce pension contributions by $527 from the amount originally certified by the State Retirement Systems because it is our belief that the State must fully fund its current pension obligations.

We are intrigued by the Interim Report's discussion of using the principles of cyclical-adjustment and dynamic-scoring. However, the implications of these principles in terms of immediate pension funding strategy require substantial vetting and analysis, especially in terms of their consistency with or viability as a replacement for the 1995 funding law (PA. 88-593), which cannot be completed in time for passage of the FY2005 budget.

I am hopeful that the Commission will take up these long-term issues in our continued deliberations this summer and next year. However, I must respectfully withhold support for the recommendations of the Interim Report because I believe the only responsible option for the State of Illinois at this time is to fully fund the originally certified pension obligation of $1.95 billion.

Sincerely,

Laurence Msall

cc: Members of the Governor's Commission on State Pensions
John Filan, State of Illinois Budget Director

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Chart 1.

Economic Principles and Pension-Funding Choices

A Heuristic Representation