



STATE OF ILLINOIS
COMPTROLLER
JUDY BAAR TOPINKA

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FISCAL FOCUS

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ILLINOIS STATE PENSION SYSTEMS A Challenging Position

After years of raiding its accounts and putting off payments for “another time,” Illinois today has the largest unfunded pension liability in the nation. That \$75 billion liability is at the forefront of discussion as the General Assembly enters the final weeks of the Spring Legislative session. But where will that debate lead?

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STATE OF ILLINOIS COMPTROLLER
JUDY BAAR TOPINKA



~ Letter from the Comptroller ~

DIFFICULT DECISIONS REQUIRED TO RETIRE STATE PENSION PROBLEM

I am pleased to present the first *Fiscal Focus* of my administration. Throughout my term, I look forward to bringing you the most up-to-date analysis of some of the most pressing issues facing the State of Illinois. While our state faces many significant budgetary concerns, perhaps none are more pressing than the issue discussed in this month's edition - public pensions.

The State of Illinois' five pension systems - which provide benefits for retired state employees, downstate teachers, university employees, judges and legislators - are seriously underfunded. This problem did not occur overnight. It is the result of years of game-playing with the pension accounts, and short-sighted decisions to raid the funds, take "pension holidays" and delay payment for "another time." Well, "another time" is upon us as the state workforce ages and baby boomers retire. When those employees retire, they rightly expect to receive what they are owed. The systems have to find ways to balance uncertain payments from the state, poor market performance affecting their investment portfolios, and employees that continue to age and retire.

As a result, Illinois' policymakers are facing difficult challenges. While the General Assembly and the Governor have taken some steps to control costs through the creation of "Tier 2" retirement benefits, the annual payments to the systems remain high and cannot be paid for by issuing debt as done in the last two years. There are no easy answers. Difficult choices will have to be made.

In this issue of *Fiscal Focus*, we examine the overall situation surrounding public pensions; Tier 2 retirement benefits, which impact state workers who began employment on or after January 1 of this year; pension bonds; and the emergence of defined contribution and hybrid plans for government employees.

We hope you find this issue to be informative. If you have any comments, please feel free to share them with us at (217) 782-6000 or at our website www.ioc.state.il.us.

Illinois State Comptroller

~ From the State Capitol ~

COMPTROLLER SEEKS REVENUE-GENERATING PARTNERSHIP

The Illinois Office of the Comptroller has initiated a package of legislative proposals in the 97th General Assembly to bring efficiency, transparency and accountability to State government. One of the most applauded legislative measures is quickly moving through both houses of the General Assembly.

The Comptroller's Office has offered legislation that would authorize the Comptroller to withhold any nontax debt due to the U.S. Secretary of the Treasury from payments made by Illinois. In a reciprocal manner, the U.S. Secretary of the Treasury will withhold any debt owed to the State of Illinois from payments made by the federal government. This change in law is expected to bring in to the State's coffers anywhere from \$6 to \$10 million annually in debts that would otherwise remain unpaid. The federal government will also recover unpaid debts owed to them.

House Bill 1527 is sponsored by Representative Lou Lang and has already passed the House 111-0-0. An identical bill is SB 2293 sponsored by Senator Pam Althoff and that has also passed unanimously in the Senate. Both bills now move to the second chamber for consideration.

This proposal will require initial start-up costs to the State's accounting system which have been agreed to and are included in the Governor's budget proposal for this fiscal year. The Comptroller will withhold a minimal fee on each transaction to cover the costs of withholding. Similar programs are underway in five states including Maryland, New Jersey, New York, Wisconsin and West Virginia. ●



Focus On Debt

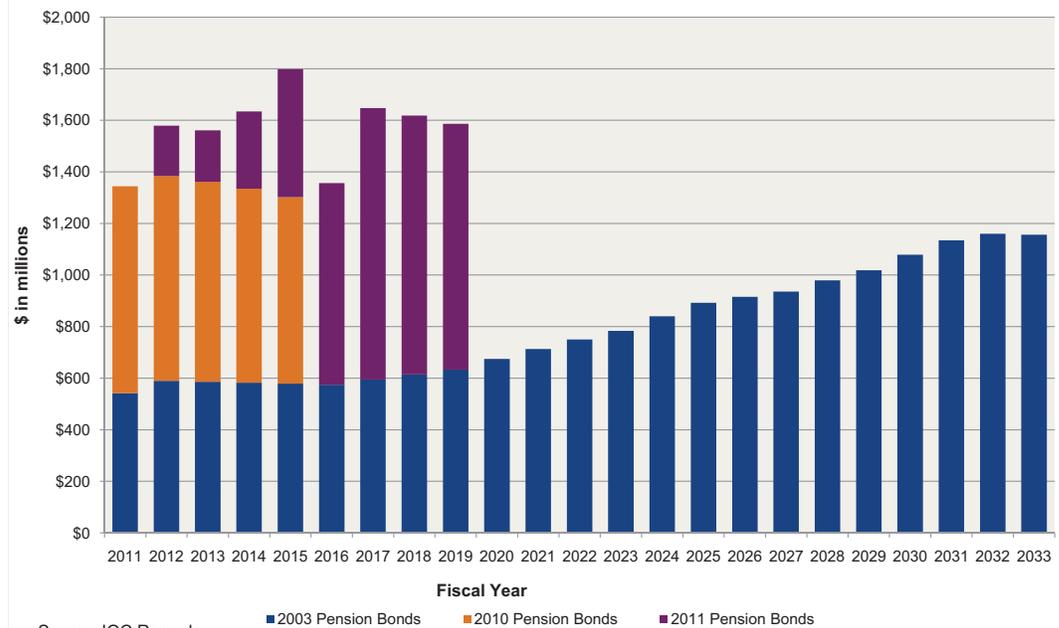
BONDS PROVIDE TEMPORARY RELIEF FOR PENSION FUNDS

Illinois issued three series of general obligation bonds to fund the pension payments of the five state systems and provide budget relief to the state. The first series, issued in June 2003, totaled \$10 billion and was partially used to pay down the unfunded accrued actuarial liability (UAAL) and assist in budget relief. The other two series issued – \$3.466 billion in January 2010 and \$3.7 billion in March 2011 – were primarily to cover the state’s General Funds share of pension contributions.

The June 2003 proceeds were divided as follows: \$7.3 billion for retirement systems; \$2.2 billion to cover state contributions to the pension funds for the fourth quarter of fiscal year 2003 and for fiscal year 2004; and \$500 million as capitalized interest to cover the first year’s debt service.

The June 2003 bonds were sold at a low 5.05% interest rate, with an average life of nearly 24 year and final maturity at 30 years. Since part of the bond proceeds were used to pay down the UAAL of the systems, the goal is to have the invested funds earn a substantially higher yield (the larger pension systems currently expect an average annual return on their investments between 7.75% and 8.5%). If successful, this will make the pension system earnings on their additional investments greater than the new state debt service payments. Of course, like all investment strategies, this plan must take into account the possibility of long-term returns falling short of expectations. Such a possibility would require the state to make additional payments to meet pension liabilities, as well as to continue to pay debt service on the pension bonds. Fortunately for Illinois, investment returns appear to have exceeded interest payments thus far.

**General Obligation Bond Debt Service
Pension Bonds**



The January 2010 bonds and March 2011 bonds were used primarily to cover the state’s mandated annual payments from the General Funds. The interest rate for the January 2010 bonds was 3.85% with an average life of 2.96 years. Those bonds will be paid off by 2015. The March 2011 bonds have an average interest rate of 5.56%, average life of 6.3 years and will be paid off by 2019. The 2011 bonds will mature at a slower rate than the 2010 bonds, but were structured that way to keep the combined debt service payments close to level and minimize the impact on the state’s budget. The accompanying chart illustrates the debt service requirements on the state’s outstanding pension bonds. The debt service on pension bonds for fiscal year 2012 will total \$1.579 billion.

In fiscal year 2012, the projected state contribution to the pension systems from the General Funds will total approximately \$4.2 billion. Among the many challenges the state will face in crafting the fiscal year 2012 budget will be how to make this payment, along with accommodating the debt service of the earlier pension bond issues. ●



Cover Story

STATE SEARCHES FOR ANSWERS

Pension funding problems plague states nationwide

The Illinois state pension systems are in a challenging fiscal position. The five main systems - the Downstate Teachers' Retirement System (TRS), the State Universities Retirement System (SURS), the State Employees' Retirement System (SERS), the Judges' Retirement System (JRS), and the General Assembly Retirement System (GARS) - ended fiscal year 2010 with a combined funded ratio of 45.4%, far short of the 90% target set forth in Illinois' 1995 funding reform plan. The state systems depend primarily on payments from Illinois' General Funds for annual funding. The challenge is to figure out how to accommodate the payments to the retirement systems and meet the commitments made to state employees and retirees, while minimizing the burden to taxpayers.

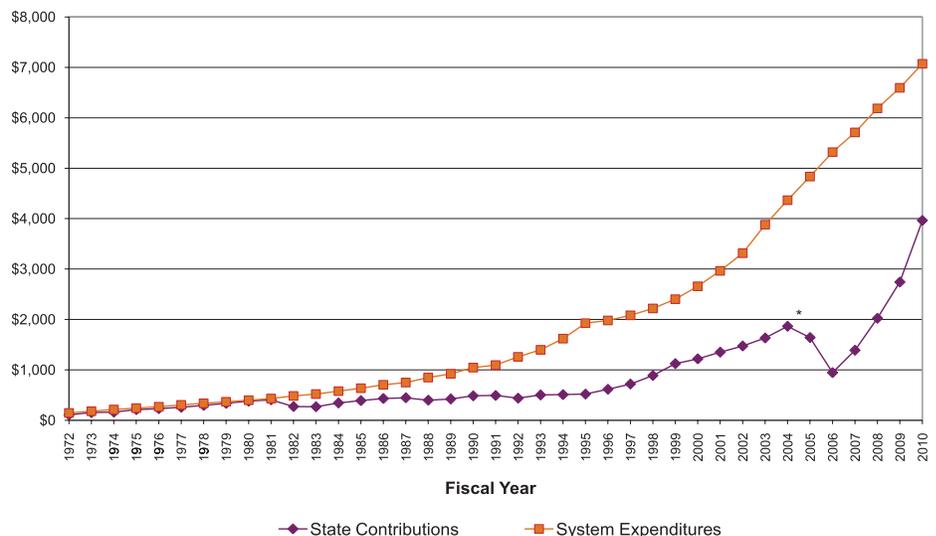
Although three of Illinois' retirement systems are among the largest and most poorly funded in the country, their difficulties are not unique. Large systems in other states have higher funded ratios than Illinois, but keeping them funded with the lackluster stock market performance and budgetary pressures from the recession is creating some of the same discussions that are taking place here.

Funding Policy for Illinois' Pension Systems

A look at the history of state contributions to the five state pension systems indicates that the funding problem was aggravated by the limited increase in state contributions between fiscal year 1981 and fiscal year 1995. Up until 1981, the budgetary policy for funding pensions was to have the employers' contribution pay the benefits, while the employees' contributions and investment income were dedicated to building a reserve for future payments. Although this funding plan had no relation to actuarial calculations of liability, it did guarantee a steady increase in state contributions.

That policy was abandoned in fiscal year 1982 during a period of fiscal stress. As a result, state contributions declined sharply in fiscal years 1982 and 1983 and increased modestly through fiscal year 1995. State contributions were \$406 million in fiscal year 1981 compared to pension system expenditures of \$431 million. Fourteen years later, state contributions were up 28% to \$519 million. Over the same

State Contributions and Retirement System Expenditures (\$ in Millions)



* Fiscal year 2004 excludes one-time infusion of \$7.3 billion from pension funding general obligation bonds.

interval, retirement fund expenditures increased almost 4.5 times to \$1.9 billion.

To correct this historic underfunding of state pension benefits, Public Act 88-593, effective July 1, 1995, created a 50-year plan to achieve 90% funding of system liabilities. The legislation included a 15-year phase-in period to allow the state to adapt to the increased financial commitment. After that (fiscal year 2010), the state's contribution is to remain at a level percentage of payrolls for 35 years, until the 90% funded level is achieved.

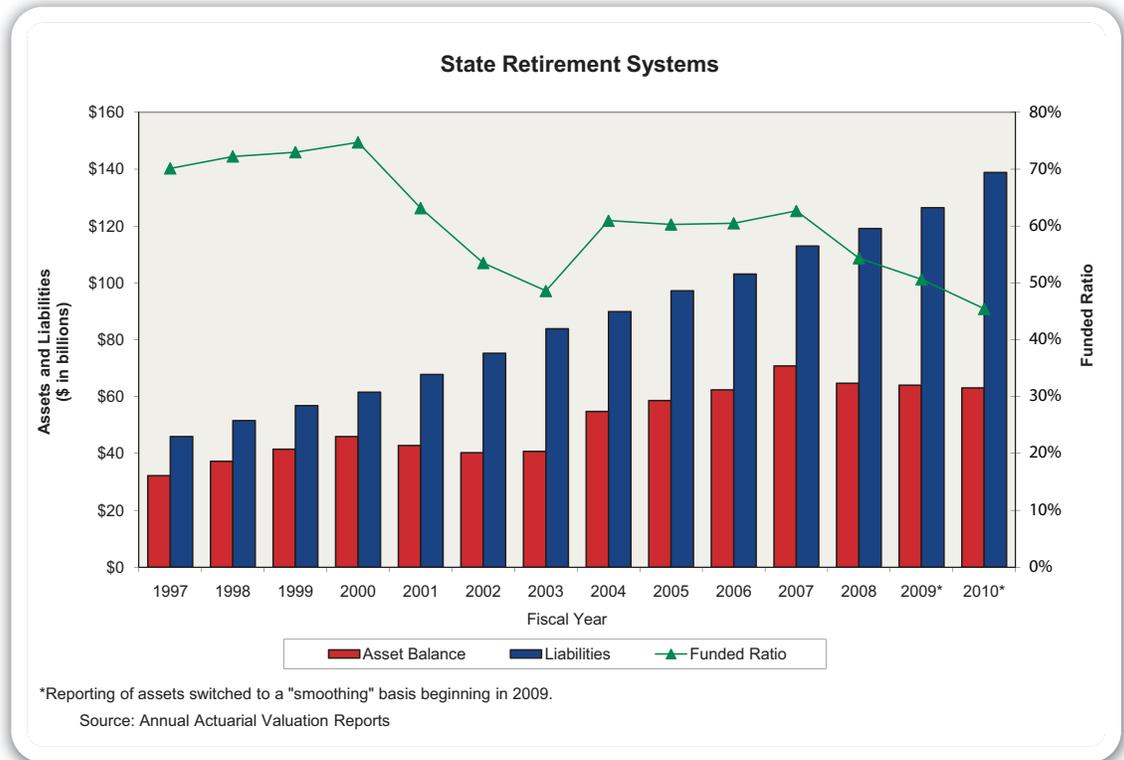
Thanks to a booming stock market, some progress was made in improving the financial condition of the Illinois pension systems between 1995 and 2000. The combined funded ratio for all the systems, which had fallen to 52.4% in fiscal year 1995, reached 74.7% in fiscal year 2000. (It should be noted that part of this improvement was due to an accounting change for valuing assets which switched from purchase price valuations to market value.)

Unfortunately, the period from fiscal year 2000 to fiscal year 2003 proved to be disastrous for the financial health of the state pension systems. With a decline in the value of equities, the value of system assets declined from \$45.9 billion at the end of fiscal year 2000 to \$40.7 billion at the end of fiscal year 2003. Over the

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same period, the steady increase in liabilities – caused in part by benefit increases – had total system liabilities growing from \$61.5 billion at the end of fiscal year 2000 to \$83.8 billion at the close of fiscal year 2003. As a result, the value of unfunded liabilities almost tripled from \$15.6 billion at the end of fiscal year 2000 to \$43.1 billion three years later, and the funded ratio declined to 48.6%.

The financial condition of the systems improved in fiscal year 2004 due to the receipt of \$7.3 billion in excess of regular contributions from the proceeds from a \$10 billion “pension funding” general obligation bond sale. The funded ratio rose to 60.9% and it remained constant over the following two fiscal years. Since then, a partial pension holiday in fiscal year 2006 and disastrous performance in the equity market in 2007-2009 has lowered the funded ratio significantly.

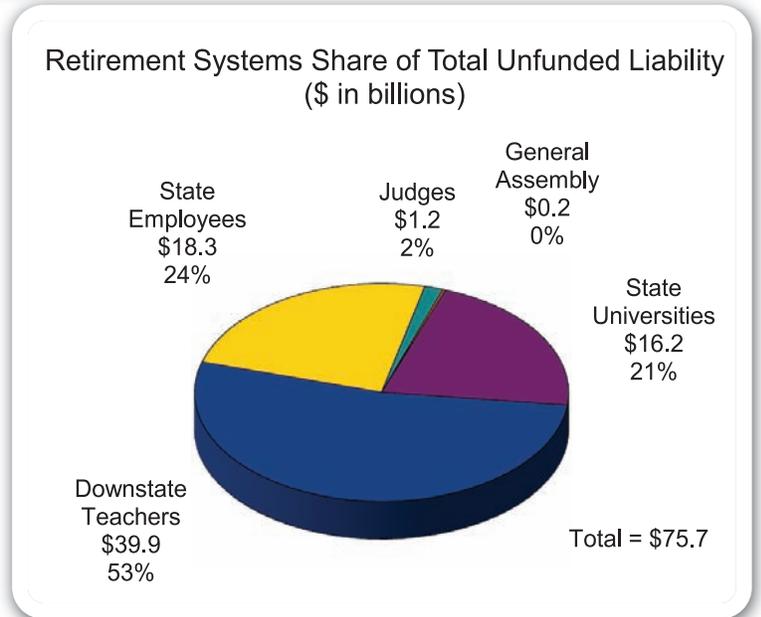


Current Fiscal Position of Illinois’ State Systems

By many measures, Illinois’ state pension systems are seriously underfunded. As of June 30, 2010, the five pension systems primarily supported by the state had accumulated \$138.8 billion in actuarial liabilities for pension, disability, and death benefits. The systems held assets valued at \$63.1 billion (using a “smoothing” basis whereby only 1/5th of the fiscal year 2009 loss in the market was counted against the end of year asset valuation) leaving \$75.7 billion in unfunded obligations. That translates into a funded level of 45.4%.

How does Illinois compare to other states?

FUNDING LEVELS. The National Association of State Retirement System Administrators (NASRA) releases an annual Public Fund Summary about the fiscal health of the major public retirement systems. The most recent report is from October 2010, including fiscal year 2009 for most systems. Out of the 126 significant state and local retirement systems surveyed (in Illinois, TRS, SURS, SERS, Illinois Municipal Retirement Fund and Chicago Teachers are included), only 14 systems reported funded ratios below 60%, with Illinois SERS lowest at 43.5%. Illinois’ two other major statewide systems were also on the list. TRS had the 4th largest unfunded accrued liability at \$30.5 billion, just behind two very large California pension systems (although both had funded ratios in excess of 75%) and the Ohio Teachers system. Overall, the average funded ratio for all systems was 78.7%, including several systems at over 100% funded.



RATES OF RETURN ON INVESTMENT. The actuarial rate of return is a long-term assessment of the likely performance of the assets of a pension system. It is a key assumption in determining the fiscal health of a pension system. During the past few months, several Illinois state pension systems have reevaluated and lowered their expected returns on investments. Entering fiscal year 2011, all five state pension systems set their assumed investment earnings at 8.0% or 8.5%. According to a 2008 survey by the Wisconsin Legislative Council, the expected return for 85 public pension systems showed a range from 7.0% to 8.5%, with 30 below 8.0%, 34 at 8.0%, and 21 above 8.0% - placing Illinois’ systems toward the upper end in the assumptions of rate of return. According to NASRA, for the

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Focus On Spending

'TIER 2' BRINGS CHANGE IN STATE PENSION PLANS

State pares down employee retirement benefits

Public Act 96-0889, effective January 1, 2011, made substantial changes to the pension plan for new government employees in Illinois by creating what is known as "Tier 2." The legislation impacted all state and local pension plans in Illinois other than the Chicago Transit Authority and police and fire department systems. Changes under the "Tier 2" plan affect retirement eligibility, benefit calculations, post-retirement benefit level increases, and survivor benefits. Overall, the new pension package is much more modest for the employee than the existing "Tier 1" plan.

The New Pension Plan

The following terms will apply to most new members of the Teachers, State Universities, State Employees, Illinois Municipal Employees, and the Chicago and Cook County pension systems. Eligibility for a full pension is raised to age 67 with 10 years of service. Starting at age 62, a pension can be taken with a 6% annual reduction for each year under 67. State police and corrections officers can retire at age 60 with 20 years of service.

The yearly credit used to determine the percent of base salary for the pension is not changed for most of the systems, but the base salary is

modified to be the highest 8 of the last 10 years of service. Limits are set on the pensions for higher wage workers as the annual final average salary may not exceed \$106,800 plus an inflation adjustment. Employee contribution rates are unchanged.

Annual inflation adjustments for annuities begin at the later of age 67, or the first anniversary of retirement, and are the lesser of the rate of inflation or 3%. Inflation adjustments will no longer be compounded.

Survivor benefits are 66.7% of the retirement benefit at death and have the same inflation adjustment as retirement annuities.

Possible Impact on Social Security Coverage

Most government pension systems in Illinois are not coordinated with Social Security. The major exceptions are the State Employees Retirement System and the Illinois Municipal Retirement Fund. The new "Tier 2" pension benefits for non-coordinated systems may no longer meet the minimum standards for the Social Security tax exemption. If the IRS determines that the new plan no longer provides sufficient retirement benefits, the employees and their

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Tier 1 versus Tier 2 Benefits*

		Retirement Eligibility	Benefit Calculations	Post-retirement Benefit Level Increases	Survivor Benefits
TRS	Tier 1	62 with 5 yrs. service, 60 with 10 yrs. service, 55 with 20 yrs. service (discounted annuity), 55 with 35 yrs. service plus an early retirement option	Base is highest 4 consecutive yrs. of last 10	3% per year of retirement compounded	50% of member's benefit
	Tier 2	67 with 10 yrs. service, 62 with 10 yrs. service (discounted annuity)	Base is highest 8 yrs. of last 10 with a \$106,800 maximum adusted for inflation	Lesser of 3% or 1/2 the inflation rate starting at later of retirement or age 67	67% of member's benefit
SERS regular formula	Tier 1	60 with 8 yrs. service, age and service combined equal to 85, and 55 with 25 yrs. service (discounted annuity)	Base is highest 4 consecutive yrs. of last 10	3% per year of retirement compounded except for dicounted annuitants under 60	50% of member's benefit
	Tier 2	67 with 10 yrs. service, 62 with 10 yrs. service (discounted annuity)	Base is highest 8 yrs. of last 10 with a \$106,800 maximum adusted for inflation	Lesser of 3% or 1/2 the inflation rate starting at later of retirement or age 67	67% of member's benefit

* Benefits for a typical member of each system and not a comprehensive list of benefits.



NEW PLAN OPTIONS FUEL PENSION DEBATE

Policymakers propose defined contribution, hybrid proposals

As the State of Illinois's unfunded pension liabilities continue to present budget challenges, several policymakers are looking at the possibility of allowing state employees to participate in defined contribution (DC) pension plans. There are several key differences between DC plans and the defined benefit (DB) plans utilized by the majority of employees in the pension systems.

DC plans provide for a retirement benefit based on what the employee and employer contribute to a member's account while that person is employed, plus the investment earnings of the plan. The amount of the payment or benefit to the retiree, however, is not guaranteed. Private-sector examples of DC plans include 401(k) plans, while public schools and certain 501(c)(3) tax-exempt organizations utilize 403(b) plans.

DC plans differ from defined benefit plans, where an employee, or their spouse, receives a set monthly payment after they retire which is guaranteed for life. Usually the monthly benefit is based on wages and years of service, and may include a cost-of-living increase during retirement.

There is a third type of pension, which is commonly referred to as a hybrid plan. Hybrid options generally blend a DC plan and a DB plan.

Whether a state employee would prefer a DC plan to a DB plan would generally depend on their circumstances. For example, employees who do not plan on working for the state for a prolonged period of time (for instance, less than the eight years it may take to get vested) may prefer a DC plan because once they leave state employment, they could take their contributions and the state's contributions, plus any earnings the plan has accumulated, and roll them into

another investment vehicle. Under current rules, if an employee leaves prior to becoming vested, he or she would only receive their contributions, and not the state's portion. Furthermore, if an employee were to stay in a DB plan, their benefit is tied to his or her salary, which may lose value relative to inflation. As the workforce becomes increasingly mobile, the opportunity to participate in a DC plan could be very attractive to a large number of employees.

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States that offer Defined Contribution/Hybrid Plans to General State Employees

Alaska	Mandated a DC plan for all new employees beginning in July 2006.
Colorado	Created an optional DC plan beginning in 2006.
District of Columbia	Mandated a DC plan for all new employees beginning in 1987.
Florida	Created an optional DC plan beginning in 2000. Those who were members of the DB plan prior to 2000 may join the optional DC plan, or a third hybrid option. The hybrid option, however, is not available to those who were employed by the state after 2000.
Georgia	Created a hybrid plan beginning in 2009. Participation in the DC portion requires an employee contribution of 1% with voluntary contributions after the first 1%. The state will match the first 1%, plus a 50% match for each percent above the first 1% up to a maximum 3% match. Employer contributions will be vested with the employee over a period of five years at 20% per year.
Indiana	Has a hybrid plan available.
Michigan	Mandated a DC plan for all new employees since 1997. The state contributes 4% of salary automatically and will match with an additional 3% of salaries with employee contributions. Employees can contribute up to 12% of salary, but only the first 3% generates an employer match.
Montana	Created an optional DC plan beginning in 2002. Employees contribute 7.17% of their salaries and the state contributes 7.37%.
Nebraska	Was a mandatory DC plan from 1967 – 2002, but they switched to a "cash balance" plan in 2003 for new employees. Under this plan, the employer controls the investments and provides a guaranteed investment return of 5% (vs. leaving all the control and risk to the employee). Employees invest 4.3-4.8% of salary and the employer contributes 7.5% of salary.
North Dakota	Created an optional DC plan beginning in 1999 for exempt employees.
Ohio	Created optional DC plans beginning in 1998. A third hybrid plan is available as well.
Oregon	Has had a hybrid plan available since 2003.
South Carolina	Created optional DC plans beginning in 2000.
Utah	Is giving their employees a choice between a DC plan and an alternative hybrid plan, beginning in July 2011. Under the DC plan, for public employees, legislators, and the governor, the state contributes 10% of the employee's salary. For public safety and firefighter members, the state will contribute 12%. A hybrid plan with DB and DC components is also available.
Washington	Has had a hybrid plan available since 2000.

Source: National Conference of State Legislatures

25 years that ended 12/31/09 (including the most recent downturn), the median annualized return for state plans was 9.25%.

However, over the last decade, the rates of return in the stock and bond markets have been relatively low, causing several retirement systems to review their actuarial assumptions about rates of return. According to an article in Pensions & Investments, the Virginia Retirement System in the last year lowered its assumption from 7.5% to 7.0%, the Pennsylvania State Employees Retirement System lowered its from 8.5% to 8.0%, the Colorado Public Employees Retirement System lowered its 8.5% to 8.0%, and the New York Common Retirement Fund lowered its assumptions from 8.0% to 7.5%. Joining this trend of using a more conservative expected return in calculating unfunded pension obligations, last fall Illinois' SURS and SERS lowered their expected return from 8.5% to 7.75% and JRS reduced its from 8.0% to 7.0%. A lower expected return on investment reduces the impact of each current and future dollar of assets held by the system, requiring increased employer contributions.

BENEFIT LEVELS. Members who joined state retirement systems prior to January 1, 2011 are eligible for "Tier 1" benefits. This is a benefit plan consistent with what most other states offered. The main distinction between the plans was SERS members paid Social Security taxes that were offset to some extent by lower employer contributions and lower pension credits for each year worked. TRS and SURS members in the defined benefit plan were not coordinated with Social Security and made a larger employer contribution and received a larger credit for each year worked.

The typical SERS member, coordinated with Social Security, contributes 4% of their payroll and receives a 1.67% credit per year served. Given this, 30 years of service would provide a 50% pension. Members could retire earlier if the sum of their age plus years of service equaled or exceeded 85. TRS members paid 9.4% of salary and received 2.2% for each year served. Vested TRS members could retire at 60, but an early retirement option is available.

Members joining the state pension systems on or after January 1, 2011 receive the more modest "Tier 2" benefits. These are described in the accompanying article on pension benefit reform in Illinois.

The Future of Government Pensions

Clearly many government pension systems, including those in Illinois, are facing fiscal challenges. What can state and local governments do to reduce their unfunded pension liabilities going forward? Mathematically the answer is simple – either change benefit structures, or meet the contribution requirements as required under Governmental Accounting Standards Board (GASB) and other funding plans (like Illinois' 1995 funding reform). The implementation of the answers is the harder challenge.

The General Assembly and the Governor have already taken steps to reduce the costs of pension benefits with Public Act 96-889, which created a different pension structure for new employees effective January 1, 2011. However, if these changes lead TRS and SURS to coordinate with Social Security, (and in turn, force higher immediate payments by the state to the federal system) the true savings may not be as large as it appears now. The article on defined contribution plans

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State Retirement Systems Fiscal Year 2010 (\$ in thousands)

	State Employees	Downstate Teachers	State Universities*	General Assembly	Judges	Total
Beginning Net Asset Balance	\$ 8,477,852	\$ 28,497,729	\$ 11,032,973	\$ 55,092	\$ 478,876	\$ 48,542,522
Income	2,141,615	6,831,193	2,625,448	16,862	137,044	11,752,162
Member contributions	246,173	899,401	275,000	1,681	16,002	1,438,256
State contributions	1,095,546	2,080,729	696,595	10,411	78,510	3,961,791
Investment income	799,896	3,679,643	1,653,853	4,771	42,532	6,180,695
Other	-	171,420	-	-	-	171,420
Expenditures	1,417,636	4,005,139	1,536,879	17,263	92,644	7,069,560
Benefits and Refunds	1,405,915	3,988,188	1,524,771	16,991	92,080	7,027,945
Administration	11,721	16,951	12,108	272	563	41,615
Ending Net Asset Balance (Fair Value)	9,201,831	31,323,784	12,121,542	54,691	523,276	53,225,124
Actuarial Value of Assets**	10,961,540	37,439,092	13,966,643	66,212	619,926	63,053,413
Actuarial Liability	29,309,464	77,293,198	30,120,427	251,765	1,819,448	138,794,302
Unfunded Accrued Liability (Fair Value)	20,107,633	45,969,414	17,998,885	197,074	1,296,172	85,569,178
Unfunded Accrued Liability (Actuarial Value)	18,347,924	39,854,106	16,153,784	185,553	1,199,522	75,740,889
Funded Ratio (Fair Market Value)	31.4%	40.5%	40.2%	21.7%	28.8%	38.3%
Funded Ratio (Actuarial Value)	37.4%	48.4%	46.4%	26.3%	34.1%	45.4%

* Defined benefit plan only; SURS also has the Self Managed Plan.

** The actuarial value is determined using the Asset Smoothing Method pursuant to P.A. 96-43

Source: Systems' Comprehensive Annual Financial Reports, 2010

(page 7) shows another option for changing benefit structures to reduce the amount of unfunded liabilities. Whether or not benefits can be altered for current state employees is a source of contention based on language in Article VIII, Section 5 of the Illinois Constitution. The issue may ultimately be decided by the courts as potential legislation changing unearned benefits for current employees has been discussed in the General Assembly.

Meeting the payment requirements under the 1995 funding plan has been a challenge in the last decade. The state's budgetary problems have made it difficult to make the payments associated with the plan's ramp up. Delaying retirement contributions may seem like an attractive option because it is a large dollar budget cut that causes minimal immediate pain. However, state history shows that delaying payments can lead to large costs down the road.

MEASURING THE FINANCIAL CONDITION OF A PENSION SYSTEM

Each of the five state systems offers a defined benefit pension plan with a guaranteed lifetime benefit calculated upon retirement, as well as disability benefits and death benefits for survivors. The pension calculation formula takes into account compensation level, years of service, provision for survivors who may also receive benefits, and whether the employee is covered by Social Security. After retirement, there is an automatic annual cost-of-living increase applied to the pension benefit in accordance with state law. SURS also offers a defined contribution plan option where the employer is only liable for its contribution.

Pension benefits are a form of deferred compensation serving as a future payment for work that is currently being performed. Accounting rules require the cost of such compensation be charged to the period when they are incurred. Actuaries for the state systems compute the current value of benefits earned each year. The sum of the current values of outstanding benefits that have been earned equals the total liabilities of the pension systems.

One of the simplest ways to measure the financial condition of pension systems is the **funded ratio** which is calculated by dividing the current value of assets held by the systems by the current value of liabilities. If assets equal the accrued liability, the funded ratio is 100% and the systems have sufficient assets to cover the amount of pension benefits that have been earned at the time the calculation was performed.

If assets are less than the accrued liability (i.e. a funded ratio less than 100%), the difference is called an **unfunded liability**. While unfunded liabilities are often less of a concern for public pension plans than for private plans (which may be terminated when a private sponsor goes out of business or is acquired by another firm), significant unfunded liabilities indicate that future taxpayers likely will have to pay for liabilities incurred in past years.

Once a large pension system becomes seriously underfunded, eliminating the shortfall can prove to be very difficult. With a fully funded system, the employer normally only needs to contribute its share of the value of benefits earned during the year (known as **normal costs**) to remain fully funded. With a seriously underfunded system, the employer needs to contribute the additional investment income that would have been earned if the system had been fully funded plus a payment toward reducing the unfunded liability in addition to the value of benefits earned during the year in order to keep the funded ratio from worsening. ●

If the payments owed under the 1995 funding plan are not feasible, what options does the state have? With the pension benefit changes enacted last spring, Illinois has taken one step toward reducing the payment obligations. Other possibilities being proposed include:

- **Issue a large general obligation bond issue**— On a scale larger than Illinois has done before, bonds could be used to pay down a large amount of the unfunded liability and reduce the annual contributions needed. Pension liabilities would switch from “soft” to “hard” debt, but possibly at a lower cost than the interest lost to the systems by deferring payments. However, a poorly timed bond issue towards the beginning of a market downturn could be very costly.
- **Revisit the timeline of the 1995 funding plan**— Illinois is nearly 35 years from reaching the 90% funding timeline set forth in that law and perhaps this timeline could be reset given the state's current fiscal trouble. This would be looked down upon by the financial community and add interest costs to the state's pension debt.
- **Create a dedicated revenue source for pension funding**— Illinois created a Pension Stabilization Fund (30 ILCS 122/20) several years ago as a place to put a portion of revenue “overperformance,” but the current thresholds for meeting this trigger are substantial. It could be rewritten to work more clearly, but it would be hard to find new money at a level significant enough to make a dent in the obligation.

Conclusion

While the challenges faced by the various Illinois systems are occurring on different scales, the overall health of Illinois' pension systems does not look as good as other states. The key challenges will be: keeping up with contributions to keep the underfunded systems solvent while the “Baby Boomers” retire in large numbers; maintaining an affordable and “fair” level of benefits; and planning investment strategies that have the systems maximizing their rates of return. ●



employer would each owe 6.2% of payroll for Social Security taxes for coverage in addition to current pension contributions. It is not clear whether this would apply to all the employees in the plan or just those who fall below the Social Security requirement.

Impact on Pension Funding

The pension reforms lead to a significant reduction in pension liabilities. Actuarial analysis commissioned by the Commission on Government Forecasting and Accountability (COGFA), as published in its fiscal year 2011 Budget Summary, estimates that the total liabilities of the five state pension systems will increase from \$133 billion in fiscal year 2010 to \$295 billion in fiscal year 2045 with the implementation of “Tier 2” pension benefits. If all employees had remained in “Tier 1,” the pension liabilities would have been \$552 billion in fiscal year 2045. The COGFA study estimated required state contributions would be reduced by \$868 million in fiscal year 2012. The average annual reduction in required contributions would be \$1.07 billion over the next ten fiscal years.

At the end of fiscal year 2010, the actuarially determined funded ratio for the five state funded pension systems was 45.4%.

The statutory pension financing plan requires constant percentage of payroll expenditures targeted to raise the funded ratio of the Illinois state pension systems to 90% by fiscal year 2045. With the significant reduction in long-term pension

**Projected Reduction in Pension Contributions due to PA 96-0889*
All State Retirement Systems
(Millions)**

FY	Contributions		Reduction
	Before PA 96-0889	After PA 96-0889	
2012	\$4,785.8	\$3,917.5	\$868.3
2013	\$5,263.5	\$4,356.2	\$907.4
2014	\$5,753.9	\$4,805.0	\$948.9
2015	\$6,243.9	\$5,251.4	\$992.5
2016	\$6,553.3	\$5,514.2	\$1,039.0
2017	\$6,854.9	\$5,767.1	\$1,087.8
2018	\$7,171.8	\$6,033.0	\$1,138.7
2019	\$7,507.1	\$6,314.8	\$1,192.3
2020	\$7,845.6	\$6,596.0	\$1,249.6
2021	\$8,207.1	\$6,897.0	\$1,310.0

Source: COGFA, State of Illinois Budget Summary, Fiscal Year 2011, July 2010

* These projections do not incorporate the impact of recent changes in pension fund investment performance assumptions which have changed the “after” column since publication of the COGFA report.

liability as “Tier 2” members assume an increased portion of public employment rolls, required state contributions to the pension systems will be far less than would have been the case without the change.

Career “Tier 2” employees (those entering government employ in their 20s and 30s and planning to stay until retirement) will not reach retirement age for many years and may not see lessened pension benefits as an immediate concern. However, as “Tier 2” employees get closer to retirement, it is possible there will be pressure from employee organizations to modify some of the provisions to more closely align them with “Tier 1” benefits. ●

FISCAL FOCUS

Fiscal Focus is one of the ways the Comptroller’s Office strives to assist taxpayers and the people of Illinois. This report is designed to provide fiscal information of general interest.

Editorial Staff: Alexis Sturm, Josh Potts, and Brad Hahn. *Writers and Analysts:* Alexis Sturm, Loren Iglarsh, and Josh Potts. *Production:* Rhonda Rathbone, Susan Hansen, Aimee Ayers-Mansfield, Frank Weitzel and Mike Petropoulos.

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Tables summarizing monthly General Funds revenue and expenditure transactions are available on the Comptroller’s website: www.wh1.ioc.state.il.us/FiscalCondition/AllGeneralFunds.cfm

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The State of Illinois could benefit by offering a DC plan as well. Under the current DB structure, the state is taking on the market risk, because regardless of how well investments perform, the amount paid out to retirees, or their spouses, is mandated. Under a DC plan, once the state contributes the amount mandated, it has met its obligations – market performance is not factored in.

Furthermore, DC plans could help force the State of Illinois to live within its means. Under a DC plan, the state must make the contributions mandated to member accounts, with no “holidays” or other skipped payments. Under the current DB plan, the state can defer contributions to the pension funds, until “later,” incurring large interest payments down the road.

It should be noted that if a state with a large unfunded liability in its defined benefit plan, like Illinois, offered a DC plan, it would likely translate into higher costs in the early years. That is because the new option does nothing to address the unfunded benefits of the original plan. In other words, the state must continue to pay those liabilities down. At the same time, the state must make its share of the payments to the employees utilizing DC plans, because as stated above, no deferrals or pension “holidays” are allowed.

Additionally, the DB plan loses the cash flow from the employees utilizing the DC plan. While this does not necessarily impact the long-term fiscal health of the plan (as no more liabilities accrue), with the same amount of dollars leaving the plan to pay current

retiree benefits while fewer dollars are flowing in, the short-term fiscal health of the plan might be impacted.

According to the National Conference of State Legislatures’¹ review of State Defined Contribution and Hybrid Pension Plans in June 2010, thirteen states plus the District of Columbia currently offer their members defined contribution and/or hybrid pension plans. State of Utah employees hired on or after July 1, 2011 will have the option of participating in a new DC plan, or a hybrid plan, as well.

In addition, several states utilize DC plans for a variety of employees, including local governmental workers, elected officials, political appointees, teachers, and others who may not necessarily be general state employees. Here in Illinois, members of the State Universities Retirement System (SURS) have the option of participating in a DC plan.

Other states are looking into adding DC plans as well. According to the New York Times², Kentucky’s state Senate passed a measure allowing state employees to participate in DC plans. State legislatures in Oklahoma and Kansas and will be studying the issue while Texas considers it as well.

With large unfunded liabilities looming, it appears that the retirement benefits of an increasing number of public sector employees may look a lot more like those of their private sector counterparts, as DC plans figure prominently into the future. ●

¹ Snell, Ronald. “State Defined Contribution and Hybrid Pension Plans,” June 2010. <http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3D&tabid=18511>

² Greenhouse, Steven. “Pension Funds Strained, States Look at 401(k) Plans,” New York Times. February 28, 2011.



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COMPTROLLER JUDY BAAR TOPINKA

Capitol Building
Springfield, Illinois 62706



COMPTROLLER JUDY BAAR TOPINKA

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Research & Fiscal Department
Attn: Fiscal Focus
Illinois Office of the Comptroller
325 W. Adams Street
Springfield, IL 62704-1871

