Illinois Downstate Police and Fire Pension Plans

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Background

- Illinois Pension Code (40 ILC 5) outlines pension benefits for public employees in Illinois
  - Each group of employees is covered under its own article
    - ✓ Article 2: General Assembly Retirement System
    - ✓ Article 3: Downstate Police Pension Funds
    - ✓ Article 4: Downstate Fire Pension Funds
    - ✓ Article 5: Chicago Police Pension Fund
    - ✓ Article 6: Chicago Fire Pension Fund
    - ✓ Article 7: Illinois Municipal Retirement Fund ("IMRF")
  - 24 total articles in this section

Background

- Every municipality in the State who has full-time police officers and firefighters is required to sponsor an Article 3 and Article 4 pension plan
  - No matter how small, most municipalities sponsor two pension plans
  - Approximately 650 total Article 3 and Article 4 funds in the State
- A Board of Trustees is established to oversee each fund
  - Each Board consists of two mayoral appointees, two active members and one retired member
  - The Board hires accountants, actuaries, attorneys, investment consultants, investment managers, etc. to help with the administration of the fund

Benefits

- Two tier system created effective January 1, 2011
  - ➢ Tier 1 – Members hired prior to the effective date
    - ✓ Normal retirement eligible upon attaining age 50 with 20 years of service
    - ✓ Maximum benefit of 75% of final salary (no averaging)
    - ✓ 3% per year COLA
    - ✓ Free 100% J&S, if married
    - ✓ Member contributions are 9.455% of pay for fire fighters and 9.91% of pay for police officers
    - ✓ Special service-related death and disability benefits

Benefits

- Two tier system created effective January 1, 2011
  - ➢ Tier 2 – Members hired on or after the effective date
    - ✓ Normal retirement eligible upon attaining age 55 with 10 years of service
    - ✓ Early retirement available at 50 and 10; 6% per year benefit reduction
    - ✓ Maximum benefit of 75% of 96-month average salary
    - ✓ Pensionable salary cap of $106,800 in 2011 (indexed)
    - ✓ Annual COLA is lesser of 3% and ½ of CPI
    - ✓ Free 66.67% J&S, if married
    - ✓ Member contributions are 9.455% of pay for fire fighters and 9.91% of pay for police officers
    - ✓ Special service-related death and disability benefits

Financial Status of these Funds

- Like most pension plans across the country, municipalities are faced with increasing contributions and declining funding ratios
  - Legislative changes have exacerbated the problem over the recent decades
- Decreasing budgets in combination with the increased contributions have placed a lot of stress on the municipalities as well as the funds
  - Illinois Public Act 96-1495 created a two-tier benefit structure and provided short-term funding relief
  - Legislators continue to examine ways to help municipalities deal with these liabilities
- Lack of funding is the primary reason funds are in their current state

Legislative Issues Facing these Funds

- No contribution enforcement mechanism
  - ➢ No ramifications if the municipality contributes less than the statutory minimum (or $0!!)
  - ➢ Pension funding has taken a back seat to other projects
  - ➢ This is consistent for all Illinois public pension funds except the IMRF Plan where contribution requirements are enforced
    - ✓ Not surprisingly, this is the best funded plan in the State
- Historically, largest plans could only invest up to 45% of the portfolio in equities with the remainder being limited to municipal bonds
  - ➢ Recent legislation allows investment in corporate bonds and up to 55% of the portfolio in equities
  - ➢ Smallest plans can invest no more than 10% in equities

Legislative Issues Facing these Funds

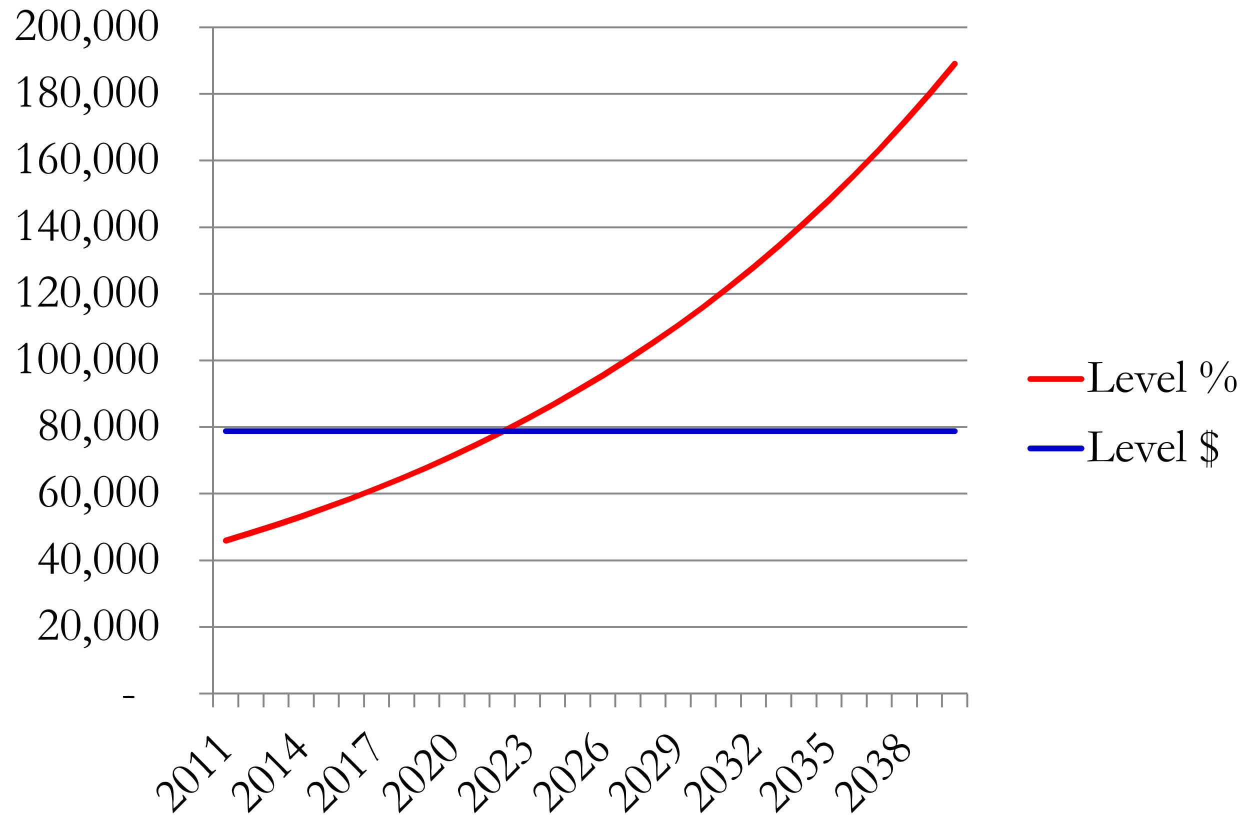
- The Pension Code outlines mandated actuarial methods to be used in calculation of statutory minimum contribution
  - ➢ Generally, these methods defer a disproportionate share of the contributions to future taxpayers
    - ✓ The problem is only going to get worse
  - ➢ The majority of municipalities have elected to make contributions based on this flawed approach
    - ✓ Gives municipalities a false sense of security
    - ✓ Many municipalities cannot afford to pay more to the funds
- In non-home rule municipalities, pension contributions are under the tax cap
  - ➢ Each dollar of pension contribution is taken from other services provided by the municipality

Mandated Actuarial Methods

- Amortization of unfunded accrued liabilities
  - ➢ Unfunded liabilities are amortized as "one-piece" rather than separate layers
  - ➢ Unfunded liabilities are to be paid off by a specific point in time
    - ✓ E.g., all unfunded liability will be eliminated by 2033
  - ➢ In 1993, the Illinois Pension Code established a 40-year amortization of unfunded liabilities on a level percentage of payroll basis
    - ✓ Plans were required to be 100% funded by 2033
  - ➢ Due to municipality concerns, Public Act 96-1495 changed the rules to require funding to 90% by 2040
    - ✓ This was not the first time the rules have changed (on average, new legislation has occurred every 15 years)
    - ✓ It will not be the last change

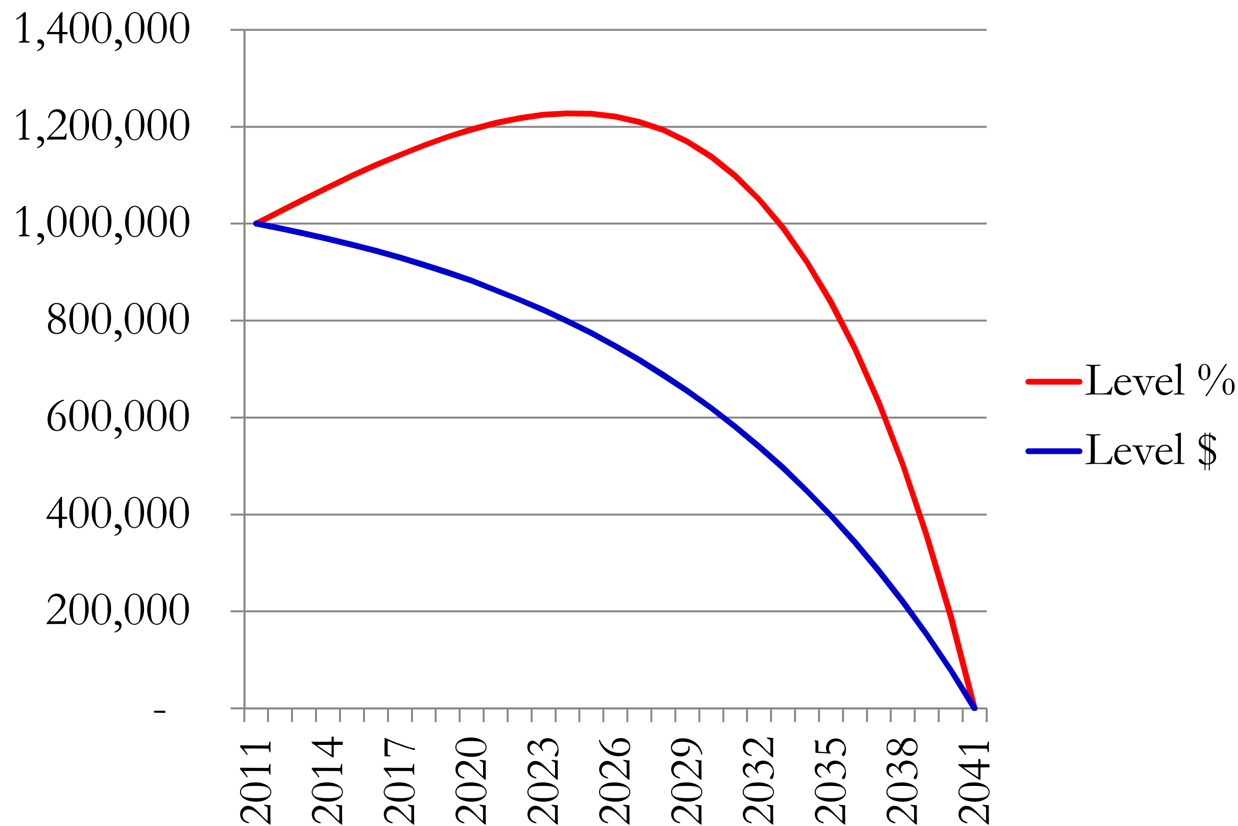
Mandated Actuarial Methods

- Amortization of unfunded accrued liabilities (continued)
  - Impact of level % of payroll vs. level dollar on the current annual amortization payment (i = 7.5%, payroll growth = 5.0%)



Mandated Actuarial Methods

- Amortization of unfunded accrued liabilities (continued)
  - Impact of a 30-year level % of payroll vs. level dollar amortization on the UAL



Mandated Actuarial Methods

- Amortization of unfunded accrued liabilities (continued)
  - ➢ Why are these plans that are going to be around forever being funded to a specific point in time?
    - ✓ What happens after 2040?
    - ✓ Future legislation will be needed or municipalities will not be able to afford the contributions
  - ➢ As each year passes, actuarial losses are paid over a shorter time period (due to "one-piece" approach)
    - ✓ A $1 million loss in 2011 is paid off over a 29 year period
    - ✓ A $1 million loss in 2031 is paid off over a 9 year period
  - ➢ Results in extreme volatility in funding requirements as we get closer to 2040

Mandated Actuarial Methods

- Projected Unit Credit (PUC) Cost Method
  - ➢ Public Act 96-1495 makes PUC the mandated cost method
  - ➢ Prior to change, Entry Age Normal Cost Method was used
    - ✓ Attempts to spread the contribution requirements evenly over a member's career
    - ✓ Used by the vast majority of public pension funds across the country since it creates or more stable and predictable contribution pattern
  - ➢ Since the vast majority of Article 3 and Article 4 Funds do not cover a mature group, this is another change to reduce short-term funding requirements

Actuarial Valuation Concerns

- Are appropriate assumptions being used?
  - Investment return – Is 7% or higher within a best-estimate range of future experience if a fund can only invest up to 10% in equities and the rest is in municipal bonds?
  - Mortality – Many municipalities are still making contributions based on the 1971 GAM mortality table
- Methods
  - Some actuaries are performing open group valuations to capture the savings of future Tier 2 members even though they will not be hired for decades
    - ✓ Many of the large State funds have utilized this approach in the past
    - ✓ See September 17, 2010 New York Times article by Mary Williams Walsh titled "An Illusion of Pension Savings"

Questions?