CHICAGO'S UNDERFUNDED PENSION PLANS

A Report to The Commercial Club of Chicago

April 2010

THE COMMERCIAL CLUB
OF CHICAGO
FOUNDED 1877

Executive Summary

In December 2006, in a report entitled *Facing Facts*, the Civic Committee's Task Force on Illinois State Finance reported to the members of the Commercial Club and the public that Illinois appeared headed toward "financial implosion." The State's liabilities and unfunded obligations were enormous, largely because of the State's unfunded pension and retiree health care liabilities. The 2006 report was updated in February 2009, and again in a report by Jim Farrell and Eden Martin to the Commercial Club in January 2010.

The *State's* five pension plans are now underfunded to the extent of approximately $76 Billion (estimated as of 12/31/09). A recent 50-state study by the Pew Center on the States showed Illinois to have the worst "funded ratio" – the ratio of assets to liabilities – in the country at the end of FY2008. At that time, Illinois had a funded ratio of 54%; it has since deteriorated to 42%.

Added to the $76 Billion of unfunded pension obligations are the additional liabilities of the State's pension bonds/notes (about $13.5 Billion) and unfunded obligations to pay retiree health care costs (estimated at $40 Billion) – for a total of about $130 Billion in retirement-related debt.

The *City of Chicago's* four pension plans have received much less attention, but on an aggregate basis, they are almost as badly underfunded as those of the State.

On January 11, 2008, Mayor Richard M. Daley announced the formation of the Commission to Strengthen Chicago's Pension Funds. The funds to be evaluated were those for the following categories of employees: firemen, policemen, laborers, and municipal employees. The Commission's assignment did not include the pensions of other municipal agencies – such as the Chicago Public Schools (Public School Teachers' Pension and Retirement Fund of Chicago), or the Chicago Park District (Park Employees' & Retirement Board Employees' Annuity and Benefit Fund).

All four City pension plans are "defined benefit" (DB) plans, similar to the State's pension plans. In these plans, a percentage of a member's salary is contributed to the fund at the end of each pay period, and an employer contribution is also made. Members then accrue creditable years of service which – at retirement age – entitle them to specified periodic payments throughout their retirement. The amount each member will receive from the pension fund is determined at the time of retirement; and the member receives that amount each year throughout retirement, whether he/she lives two years or thirty years thereafter.

DB plans are thus to be contrasted to "defined contribution" (DC) plans, in which a participant would contribute specified amounts each month or year; and the amount of retirement benefit available upon retirement to the participant would depend on how much had been contributed and the investment returns earned by those funds. Chicago does not sponsor a DC plan such as a private sector 401(k) or a public sector 403(b) plan. However, Chicago – and CPS – do offer 457 deferred compensation programs.

In certain respects, Chicago's pension plans are even more generous than those of the State of Illinois. The State's pension plans permit retirement with undiminished pensions at ages 60 or even 55, with the requisite number of years of service. Chicago's four pension plans permit retirement with undiminished pensions at age 50, with the requisite number of years of service. This enables many retirees from Chicago's employment, at age 50 or soon after, to "retire" and then go to work at another government job, get paid for that job, and start generating additional pension rights.

Chicago's pension plans – like the State's – are now dangerously underfunded. At the end of FY2009 (calendar year 2009), the unfunded pension liability of the City's four pension funds totaled about $14.6 Billion, with an aggregate funded ratio of only 43% – about the same as the State's. (This means the funds, as a group, as of December 31, 2009, had only about 43% of the value that would be needed to meet the plan liabilities.) The Policemen's and Firemen's funds were in the worst fiscal condition, with funded ratios of only 37% and 30%, respectively.

If the assets in Chicago's pension funds earn in the range of 4-6% in coming years, the Firemen's fund would run out of money in approximately 2019-2020, and the Policemen's fund would run out shortly thereafter. (Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations.*)

What would it take adequately to fund the Chicago pension plans if no reforms are made?

- In FY2009, in accordance with the State-prescribed funding formula, Chicago funded its four plans to the extent of $443 Million, and City employees contributed an additional $271 Million – for a total contribution to the pension plans of $715 Million. In FY2012, assuming no changes in plan benefits or State-prescribed funding formulas, the total contribution would increase to $793 Million.

- The problem is that the State funding formula is set too low – geared to the perceived ability of the City to contribute, rather than actuarial standards.

- The Mayor's Commission found that if no reforms were made to plan benefits, but if annual pension funding were increased to *actuarially-required* levels, in FY2012 total contributions to the pension funds would have to increase from $793 Million (the present State formula level) to $1.503 Billion – *an increase of $710 Million.* (Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations.*)

Although the staff of the Mayor's Commission did a fine job (with assistance from Deloitte and Aon) of analyzing the facts, the mission of the Commission was also to come up with recommended steps to deal with the problem. It was here – despite the best efforts of the Commission's leadership, staff and consultants – that the Commission was unable to do its job. The majority of the Commission recommended reform as to "new" employees – i.e., employees to be hired in the future. But they did not agree to reforms that would prospectively alter pension terms for current employees (while protecting all benefits they had already earned).

Three members of the Mayor's Commission dissented because they believed the recommendations did not go far enough. They were Lester Crown, Eden Martin, and Laurence Msall (President of the Civic Federation).[1]

The Mayor's Commission concluded its work on March 24, 2010, and presented its report to the Mayor on March 31st. During that intervening week, the Illinois Legislature enacted pension reform which applies not only to State employees and members of the State's pension plans, but also to many municipal pension plans throughout the State. In particular, the newly-enacted reforms apply to Chicago's plans for municipal employees and laborers, and also to Chicago's plan for CPS teachers. However, the Legislature exempted fire and police pension plans throughout the State.

The Mayor's Commission recommended pension reform only as to "new" employees – those to be hired in the future. The Illinois Legislature enacted a version of that reform – limited to "new" employees – but not including the fire and police employees.

Neither the reforms recommended by the Mayor's Commission nor those enacted by the Legislature would reduce the Chicago funds' existing $14.6 Billion unfunded pension liability. Nor would either version of reform reduce Chicago's current *annual pension costs* – the amounts which, under actuarial standards, should be contributed each year to keep the pension liability from continuing to grow.[2]

By contrast, the recommendations offered by the Civic Committee at the State level, and endorsed by Messrs. Crown, Martin, and Msall for application at the City level, would reduce the Chicago plans' unfunded liability by about $4.4 Billion, and would also reduce the cost of the plans by approximately $400 Million per year, beginning immediately following implementation of the reforms.[3]

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[1] This report by Lester Crown and Eden Martin draws on factual materials presented to the Mayor's Commission. However, the analysis and presentation of the material and recommendations are their own. Laurence Msall has appended a statement of his own views (Appendix A).

[2] The majority report of the Mayor's Commission suggests that the proposed reform as to new employees would create "savings" of about $150 Million in FY2012. This is not because of cost reductions that would actually be achieved in FY2012. It is rather because the City would in effect "up front" cost savings to be achieved in future decades in order to justify reducing pension *funding* to the extent of $150 Million in FY2012. A funding formula which keeps unfunded liabilities from growing is far preferable to one – such as the level % of pay formula which the City uses in its Scenarios – that allows the unfunded liabilities to grow.

[3] The majority report of the Mayor's Commission refers to estimated annual savings from the Civic Committee proposed reforms of only about $350 Million in FY2012, but this is based on a level % of pay formula that the City uses in its Scenarios. Using a Normal Cost Plus Interest standard for calculating

I. THE FOUR CHICAGO PENSION FUNDS

Employees of the City of Chicago are members of one of four Pension Funds, each created under the Pension Code of the State of Illinois (40 ILCS 5/). The four funds are as follows:

Firemen's Annuity and Benefit Fund
Policemen's Annuity and Benefit Fund
Laborers' and Retirement Board Employees' Annuity and Benefit Fund
Municipal Employees', Officers', and Officials' Annuity and Benefit Fund.

In addition to City employees, non-instructional employees of the Chicago Public Schools (CPS) are also members of the Municipal Employees', Officers' and Officials' Annuity and Benefit Fund, constituting approximately one half of its members.[4]

Funding for the pension plans comes from employee and employer (City) contributions each year. The four Chicago pension plans are governed by State law, and the State determines the amount that the City must put into the funds each year. Just as in the private sector, total funding is supposed to be sufficient to maintain adequate investments in the funds so that the value of these investments (assumed to grow at an average rate of about 8% per year) is approximately equal to the present value of the obligations. If the funds are approximately 100% funded, then the value in the funds should be adequate to pay the future pension benefits that have been earned by employees up to that date. As funding levels drop below 100% – either due to past inadequate funding or for other reasons – then annual contributions must cover (1) current "normal costs" of future pensions, and also (2) "past costs" that have not been adequately funded.

So long as the value of the funds remains reasonably close to 100% of the liabilities, there is little cause for concern. When funding levels drop below 90%, concern increases because total annual contributions must fund not only the current "normal costs," but also the increasing value of the "past costs." Because unfunded liabilities grow by virtue of the reversal of the discount rate each year, small gaps in funding can quickly become larger gaps – as larger and larger amounts of unfunded costs are shifted to the future, growing at a compounded rate of 8% per year.

The claims of retirees to receive pensions from the four pension plans are governed by State law. The rights of City retirees to receive pensions are rights vis-à-vis

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pension costs results in "interest" savings alone of $352 Million ($4.4 Billion X 8%) with additional reductions in normal cost, which would bring total cost savings to at least $400 Million.

[4] Chicago's sister agency pension funds were not subject to the Mayor's Commission review, and are not covered in its report. These funds include the Public School Teachers' Pension and Retirement Fund of Chicago (75.5% funded based on market value of assets in FY2008) and the Park Employees' & Retirement Board Employees' Annuity and Benefit Fund (70.7% funded based on market value of assets in FY2008). (Source: "Status of Local Pension Funding Fiscal Year 2008: An Evaluation of Ten Local Government Employee Pension Funds in Cook County," The Civic Federation, March 8, 2010, p. 16.)

the pension funds themselves – not the City. This point is of central importance in considering what should now be done to address the underfunding problem.

First, Section 5, Article XIII of the Illinois Constitution, provides as follows:

> *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. (Emphasis supplied.)

Section 5 was added to the Constitution in 1970 because of judicial decisions which cast doubt on whether membership in a pension system created a contractual right on the part of the member/retiree against that pension system.[5] Section 5 eliminated that doubt – making it clear that membership in the pension system "shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Thus, the relationship of the member to the pension system is to be regarded as a contract, the rights under which are protected. It is the pension system with which the contract relationship exists – not the City. It is thus the pension system that is responsible for any claims.

Second, Illinois statutory law – Section 403, 40 ILCS 5/22 – reinforces the point that any member/retiree pension claims are against the pension system – not the City:

> Any pension payable under any law hereinbefore referred to shall *not* be construed to be a legal obligation or debt of the State, or of any county, city, town, municipal corporation or body politic and corporate located in the State, other than the pension fund concerned, but shall be held to be *solely* an obligation of such pension fund, unless otherwise specifically provided in the law creating such fund. (40 ILCS 5/22, Section 403, Laws 1963, p. 161.) (Emphasis supplied.)

The City's obligation is thus to pay money into the pension funds in accordance with the schedule provided by the State – but apparently not to guarantee payment of the pensions if the funds were to run out of money.[6]

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[5] Prior to 1970, in cases where membership was mandatory rather than voluntary, it had been argued – and sometimes decided – that in the absence of voluntary agreement, there was no contract – and therefore no contractual right (see, for example, *McNamee v. State*, 173 Ill.2d 433, 439-440 (4th Dist. 1982.))

[6] In *Houlihan v. City of Chicago*, 714 N.E.2d 569 (App. Ct. Ill. 1999), the court addressed the extent of the City of Chicago's funding obligations under the Pension Code. Participants in four Chicago employee pension funds brought a class action asking the court to compel the City of Chicago to pay interest on employer contributions that were being paid into the funds on a delayed basis. The court held that the City had no obligation to pay interest, reasoning that "the maximum allowable tax levy authorized by the Pension Code is the maximum amount that the City may contribute to the funds." *Id.* at 573. The court further held that once "the City has contributed the maximum amount allowable to the funds [,] . . . the City cannot contribute additional money to the pension funds." *Id.* at 576.

It should be noted that Chicago employees are not participants in the national Social Security (SS) system. At one time, Chicago employees had an opportunity to participate in the SS system, but chose not to do so, thus enabling them to retain the money they would otherwise have had to contribute to that system. Therefore, when a Chicago employee retires, he/she must look to the Chicago DB plan and to any other savings for retirement, including any moneys in deferred compensation programs.

Three key factors with respect to any pension plan are: the benefits it affords employees, the plan's liabilities, and the plan's assets.

A. Benefits

The benefit levels of the four Chicago plans vary. Unreduced retirement annuities are available at age 50 with 20 or 30 years of creditable service, depending on the plan. Maximum pensions are 75 or 80% of final average compensation (calculated using the highest four consecutive years within the final ten years), and overtime pay or bonuses are not included in the calculation.

The four plans include provisions for disability payments. Because City employees are not in the Social Security system, they are ineligible for SS disability payments or survivor benefits. With the exception of disability benefits in the Police and Firemen's plan, these are relatively small expenses and are not significant contributors to the financial condition of the plans.

The four plans also include a provision for an automatic cost of living adjustment (either 1.5% or 3% depending on the plan) each year that is unrelated to the level of actual inflation or the CPI.

B. Liabilities

A pension plan's accrued liabilities are the sum of the monthly payments (estimated) that it will have to make to plan participants when they retire, based on the benefits the participants have earned to date. These payments will generally be paid out at different times in the future. Therefore, simply adding them up ignores the time value of money. However, actuaries can determine the "present value" (PV) of these liabilities – in today's dollars – by discounting the payments that will have to be made in future years. The resulting PV of the accrued liability of any pension fund thus represents an estimate of today's "value" of the accrued liability of the plan – what the plan would have to pay a willing buyer (or group of buyers) today to take on that liability.

The typical actuarial practice for public pension plans is to use a discount rate of between 7% and 8.5% to determine the PV of the accrued liabilities of the fund. These particular rates have been used because they arguably approximate the long-term returns the assets in the pension funds are expected to earn. Such estimates are based on the historic returns of investment funds over the past several decades adjusted for future expectations. The Chicago funds have used a discount rate of 8% (unlike the State of

Illinois which has generally used an 8.5% rate).[7] The accrued liabilities of the funds are calculated based on many factors in addition to the discount rate, including assumptions about the number and timing of future retirements, salary levels and years of pensionable service that retirees will have, mortality rates, and provisions for cost-of-living adjustments.

C. Assets

The pension plan's assets are the stocks, bonds and any other investments held in the pension fund at a particular time. The value of those assets can usually be readily determined by checking reported market values – the prices at which assets have recently traded. Sometimes pension funds have adopted "smoothing" formulas – as Chicago's funds have – for purposes of determining what periodic contributions should be made to the funds. But such formulas do not alter or affect the actual market value of the assets in the funds. They are what they are. They are worth what they could be sold for.

The assets in a pension fund – divided by the PV of the pension fund's liabilities – may be defined as the "funded ratio." It is the degree to which the liabilities are covered by assets. If the PV of the liabilities were 50, and the asset values were also 50, then the "funded ratio" would be 100%. The plan would be said to be 100% funded.

Because market values fluctuate more than the PV of a pension plan's liabilities, it is unlikely that at any particular time the "funded ratio" would be exactly 100%. But ideally the ratio should approach 100% over time. To the degree the "funded ratio" is significantly less than 100%, the ability of the pension fund to make good on all its obligations comes into question. A "funded ratio" of 90, or even 80, is not cause for great immediate concern because the pension funds are paid out over a period of decades; and during those decades market values may rebound from recessionary levels. Also, contribution levels can be adjusted.

However, when the "funded ratio" of a plan slips much below 80%, the level of concern is increased. This is in part because the annual cost of funding the plan increases.

D. The Annual Required Contributions – the ARC

Actuaries determine how much should be contributed to a pension plan each year with the ultimate goal of assuring that the plan has adequate assets to meet future obligations. If each year's normal costs (i.e., the cost of benefits accruing during the year) are not covered by each year's contributions, then the normal cost for a particular period

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[7] Economists argue that the return expected for pension plan assets is irrelevant to the present value of plan liabilities, which should be determined using a discount rate that reflects the near-riskless character of the payment stream of accrued benefits. Using the higher discount rate based on the assumed return on plan assets understates plan liabilities and the extent of underfunding. ("The Liabilities and Risks of State-Sponsored Pension Plans," Robert Novy-Marx and Joshua D. Rauh, *Journal of Economic Perspectives*, Volume 23, Number 4, Fall 2009, Pages 191-210.)

(which are part of operating costs) are in effect shifted off to future budgets and future taxpayers.

Although the Annual Required Contribution, or ARC, is a GASB accounting term for the annual pension expense that should be included in a plan sponsor's profit and loss statement, it also represents a reasonable benchmark contribution requirement for public plans. The ARC consists of two components: (a) the "normal" cost each year, and (b) an amortization payment (consisting of both an interest payment and a principal payment) of the unfunded liability.

If a plan is fully funded ("funded ratio" equals 100%), and it is closed with no more benefits accruing, then the current assets would be sufficient to pay all the benefits its members have earned to date over time, assuming all actuarial assumptions are met. When a plan is fully funded, each year the normal cost of the plan is equal to the PV of the increased obligation assumed by the plan by virtue of the fact that the employees have accrued one year's additional entitlement under the plan.

But if a plan is not fully funded, then in addition to the normal annual cost, the total annual contribution should include an additional amount equal to 8% of the unfunded balance in the plans (sometimes called an "interest" payment) in order to keep the unfunded liability from growing. In order to *reduce* the unfunded liability, in addition to the interest payment, the annual contribution should also contribute an amount to reduce (amortize) the unfunded liability.

When the funded ratio of a plan slips much below 80%, the amount of the ARC rises significantly because of the second component. For example, if a plan is only 40% funded, this means that the annual contribution should include not only (a) the "normal" cost, but also (b) 8% on 60% of the total PV of the accrued liabilities in the plan (the unfunded liability) plus an additional amount to pay down the principal of the unfunded liability. If a plan were only 30% funded, this latter contribution requirement would rise to 8% of 70% of the total PV of the accrued liabilities in the plan plus an additional principal payment on the unfunded liability.

It is thus a very slippery slope. When it becomes hard to make the required annual payments, and less-than-required contributions are made, this increases the funding requirements in the future – when it may be just as hard if not harder to make the required payments.[8]

The State of Illinois has enacted legislation that sets funding requirements for both State and municipal pensions throughout Illinois. The formulas embodied in these requirements are more relaxed than those imposed by the Federal Government on private-

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[8] In the private sector, the goal is that pension plans maintain 100% funding ratios. If a pension plan in the private sector falls below that level, federal law requires that it must increase contributions to amortize the shortfall over 7 years. The federal Pension Benefit Guaranty Corporation (PBGC) guarantees the payments of those pensions, and the requirements are imposed to control risk to both the funds and the PBGC. The PBGC does not insure public sector pensions, and the rules applicable to the private sector do not apply to the public sector.

sector pensions. In 1995 the State amended the Pension Code to put the State's five major pension plans on a path to reach 90% funding within 50 years. However, the contribution levels set by the State for its plans were determined not based on the ARC; instead, contribution levels were back-end loaded and were "ramped up" in the early 15 years of the period. In addition, in some years the State changed the State Pension Code so it did not have to make contributions even at the original formula level – a practice sometimes referred to as taking a "partial pension contribution holiday."

State statutes also determine the funding requirements for the four plans for Chicago employees. As in the case of the State plans, these funding requirements have not been set based on the ARC. Instead, the contribution structure of the four plans provides that (a) employees will contribute a set percentage of each payroll, and (b) the City will provide a matching amount that is a multiple of total employee contributions two years earlier. The current percentages and multiples are:

Figure 1

Funding Provisions
(Chicago's Four Pension Funds)

	Fire	Police	Laborers	Municipal
Employee Contribution (% of Payroll)	9.125%	9.000%	8.500%	8.500%
City Multiple	2.26	2.00	1.00	1.25
City Contribution (% of Payroll 2 years prior)	20.6225%	18.000%	8.500%	10.625%
Total Contribution (% of Payroll)	29.7475%	27.000%	17.000%	19.125%

Source: Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations*.

These contribution levels, set by State law, bear no relationship to the actuarial liabilities of the plans and they are much lower than the GASB ARC.

Accordingly, it is not surprising that the Chicago pension funds have become underfunded over the years. This occurred primarily because the contributions were based on an arbitrary fixed formula rather than actuarial liabilities being accrued by the plans. This underfunding has been further aggravated by the deterioration in asset values that occurred in 2008.

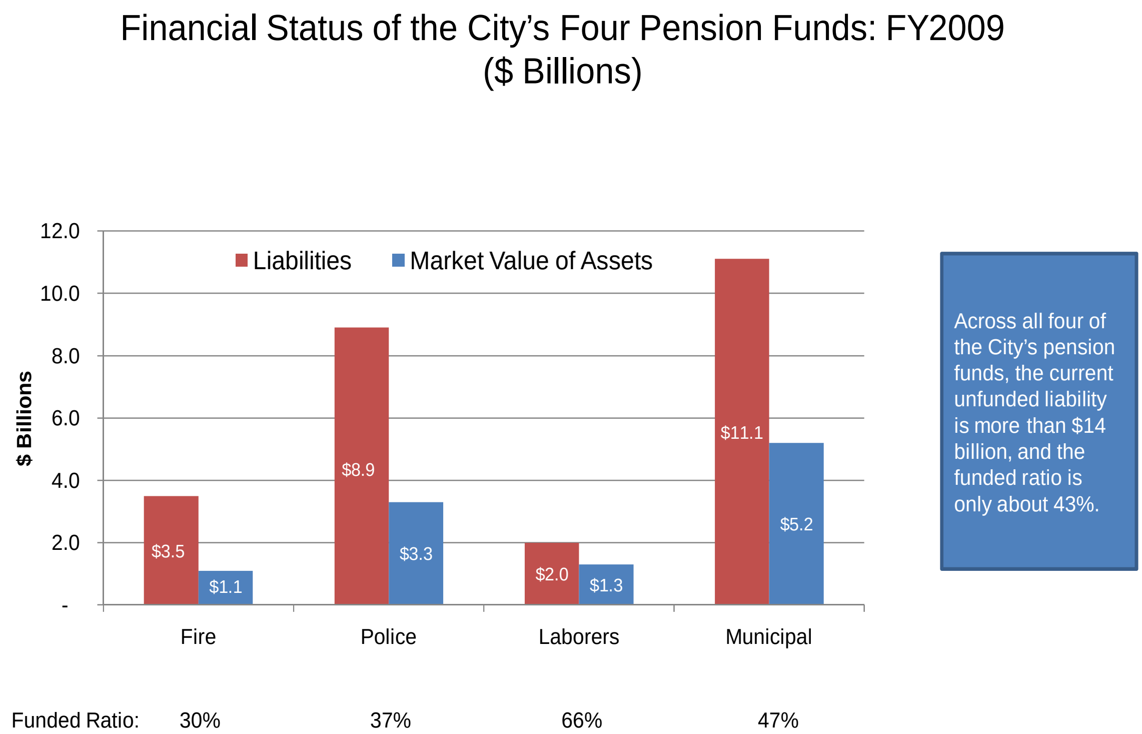
II. CHICAGO'S FOUR PENSION PLANS ARE NOW DANGEROUSLY UNDERFUNDED

During the several years preceding the appointment of the Mayor's Commission in early 2008, the funded ratios of the City's four pension funds had declined. By the end of FY2006 (the latest information available when the Commission was appointed), the aggregate funded ratio of the four plans was 62%, and the aggregate unfunded liability of the four funds exceeded $8.5 Billion.

Things have grown worse since that time. As of the end of FY2009 (December 31, 2009), the PV of the liabilities in the four funds was about $25.5 Billion. As of the same point in time, the assets were valued at only $10.9 Billion, leaving an unfunded liability of around $14.6 Billion. The aggregate funded ratio was thus about 43% as of December 31, 2009.

However, the aggregate data are less useful than an examination of the status of each of the four funds. This is because assets from one fund may not be used to pay off the liabilities of another fund.

Figure 2



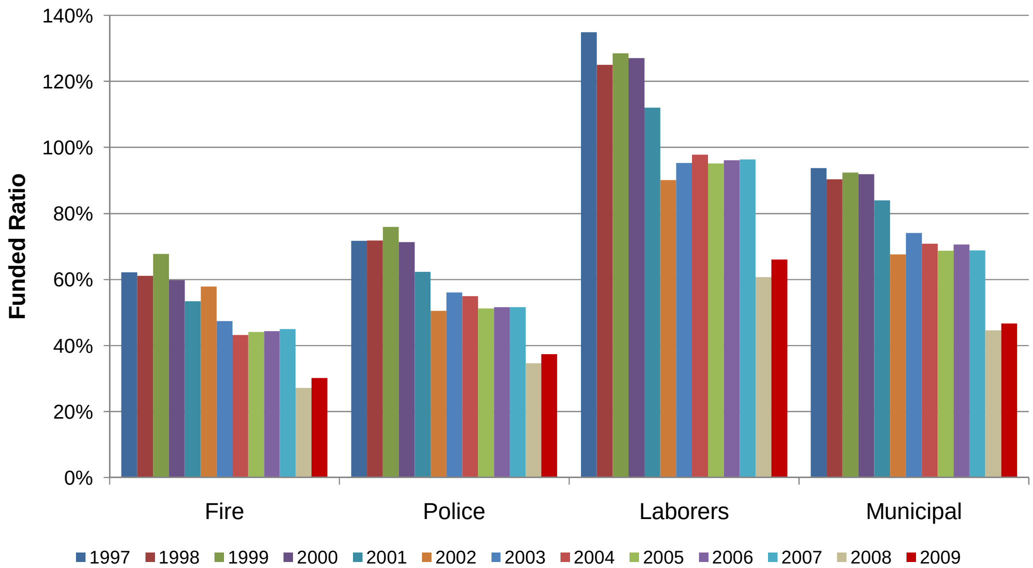
Source: Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations,* as amended by 4_23_10 email from M. Johnson.

Figure 2 (using the most current available data – as of the end of FY2009) shows that each of the funds is seriously underfunded, with the Firemen's fund closest to running out of money. The Laborers fund is the best funded of the four – at about 66%. Most of the unfunded liability is in the Policemen's and Municipal funds.

Figure 3 shows that this underfunding has been gradually building over the past decade. The funding ratios dropped in 2008 as asset values plummeted due to the stock market declines. But the ratios were already low – particularly in the Firemen's and Policemen's funds – before 2008.

Figure 3

Funded Status Over Time of Chicago's Four Pension Funds
(Market Value of Assets)



Source: Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 2: Resources,* as amended by 4_23_10 email from M. Johnson.

The underfunding is now so serious that unless steps are taken soon – some combination of pension reforms, increased contributions, or a dramatic increase in the market value of assets in the funds – these funds will run out of money. If and when that happens, the funds will not be able to pay amounts owed to annuitants as they become due.

Figure 4

When City Pension Funds Run Out of Cash
(Assuming Different Asset Returns)

	Assumed Rate of Return on Assets					
	0%	**4%**	**6%**	**8%**	**10%**	**12%**
Fire	2019	2019	2020	2022	2024	2027
Police	2019	2021	2022	2024	2028	2032
Laborers	2021	2024	2026	2030	2041	2059+
Municipal	2020	2023	2024	2027	2032	2051

Source: Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations*.

Figure 4 shows (based on year-end 2009 data) that if the Firemen's Fund earns 8% on assets now in the fund, it is projected to run out of cash in approximately 2022. If the assets in the Firemen's Fund do not increase in value (i.e., earn a 0% return), it will run out of cash in approximately 2019.

The Policemen's Fund would run out of cash shortly thereafter.

III. THE CAUSES OF CHICAGO'S PENSION UNDERFUNDING

Why have the funding ratios of Chicago's four pension plans deteriorated?

Evidence submitted to the Mayor's Commission suggests that the causes vary from fund to fund. Figure 5 shows the 1997 funded ratio and the 2007 funded ratio for each of the City's funds, and then shows what part of the decline in the funded ratio over the 1997-2007 period was attributable to different causes. The primary cause in the case of the Firemen's fund and the Policemen's fund was a shortfall in contributions over this time period. But in the case of the Laborers' and Municipal funds, the principal cause was benefit changes.

Figure 5

Causes of Decline in Funded Ratio from 1997-2007
(Chicago's Four Pension Funds)

	Fire	Police	Laborers	Municipal
1997 Funded Ratio	**59.7%**	**62.8%**	**127.6%**	**84.9%**
- Expected Change	18.2%	15.2%	(4.7%)	7.0%
- Contribution Shortfall	(20.2%)	(14.6%)	7.8%	(1.5%)
- Investments	(2.9%)	(1.1%)	(5.0%)	(1.7%)
- Benefit Changes	(6.5%)	(4.2%)	(34.6%)	(18.5%)
- Other Factors	(6.1%)	(7.7%)	4.0%	(2.6%)
2007 Funded Ratio	**42.1%**	**50.4%**	**95.0%**	**67.6%**

Source: "Current State; How We Got There; What's Ahead," May 7, 2008 Presentation to the CSCP, Gabriel Roeder Smith & Company, pp. 18, 21, 22.

Also, as already noted, the decline in asset values in 2008 contributed to the underfunding of all four funds.

A further factor is that the benefits provided by the City's four pension plans are significantly more generous than those available to taxpayers in the private sector. Figure 6 below summarizes the key provisions of the four Chicago plans.

Figure 6

Key Plan Provisions
(Chicago's Four Pension Funds)

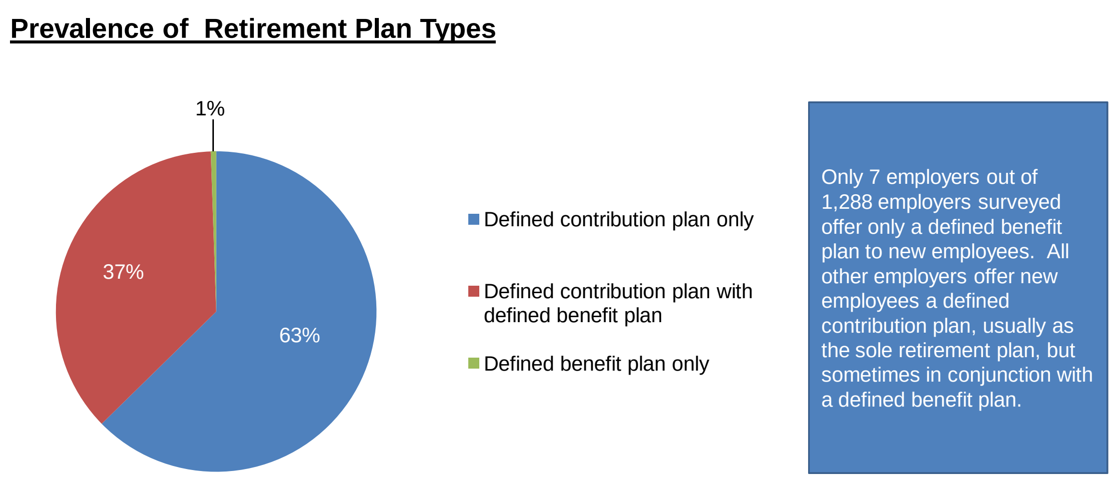
	Fire	Police	Laborers	Municipal
Unreduced Retirement Eligibility	50/20 yrs svc 63/10 yrs svc (Mandatory retirement at 63)	50/20 yrs svc 63/10 yrs svc (Mandatory retirement at 63)	50/30 yrs svc 60/10 yrs svc 55/25 yrs svc	50/30 yrs svc 60/10 yrs svc 55/25 yrs svc
Benefit Accrual Rate	2.5%	2.5%	2.4%	2.4%
COLA	1.5%	1.5%	3.0%	3.0%
Final Average Compensation	High 4 consecutive years within last 10	High 4 consecutive years within last 10	High 4 consecutive years within last 10	High 4 consecutive years within last 10
Employee Contribution	9.125%	9.00%	8.5%	8.5%

Source: Commission to Strengthen Chicago's Pension Funds Final Report, *Volumes 1 and 2*

Most employers in the private sector have been forced by competition and economic circumstances to shift away from pure defined benefit plans – moving to defined contribution plans or hybrid plans combining elements of both DB and DC.[9]

Figure 7

Prevalence of Defined Benefit and Defined Contribution Plans in 2009:
New Employees in the Private Sector

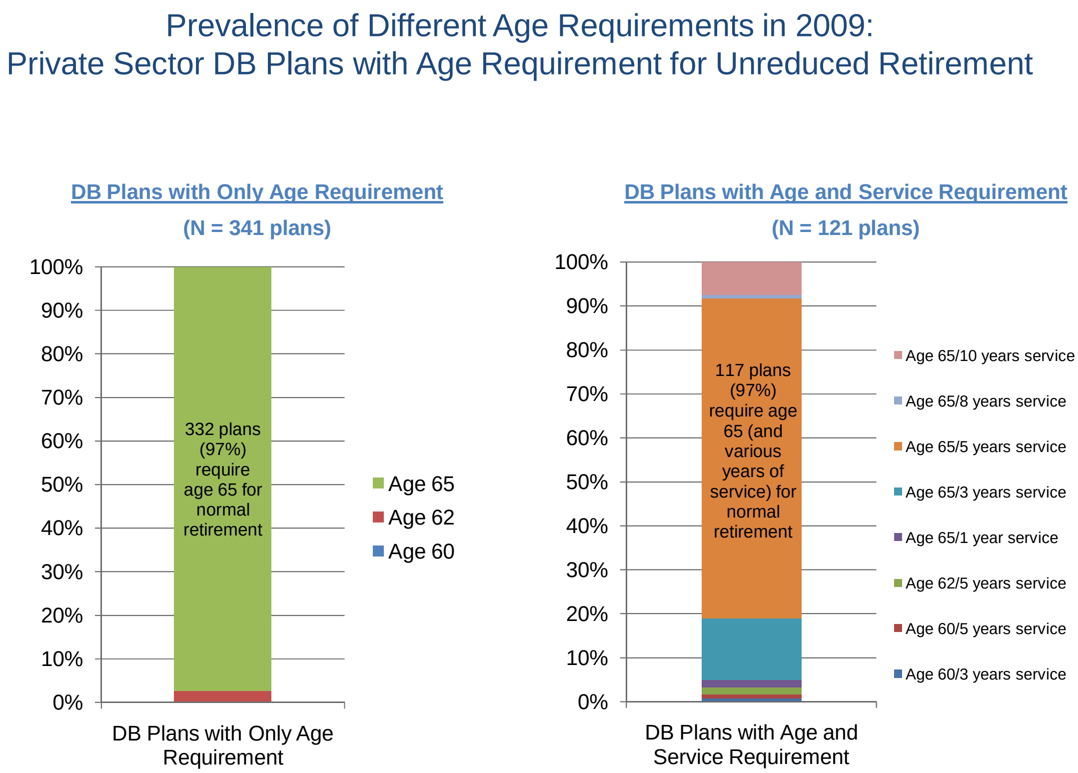


Source: Hewitt Associates, LLC database of large employer plan specifications, covering over 1,000 major employers and including 80% of Fortune 500

[9] Private sector employees also participate in Social Security, which requires additional contributions (6.2% of wages up to the Social Security Covered Wage Base, which is currently $106,800) by both employee and employer each year, and provides additional benefits upon retirement.

Few private-sector employees are able to retire with unreduced benefits in a DB plan at the age of 50 or 55. Figure 8 shows that most private sector defined benefit plans (almost always offered in conjunction with a defined contribution plan) require age 65 for unreduced benefits.

Figure 8

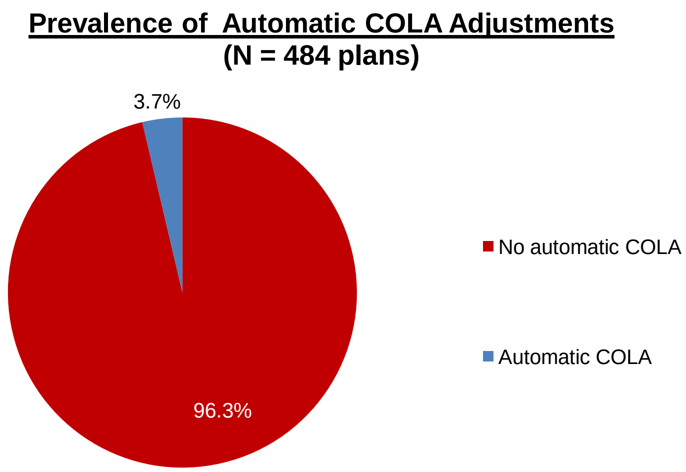


Source: Hewitt Associates, LLC database of large employer plan specifications, covering over 1,000 major employers and including 80% of Fortune 500

Similarly, very few private sector employees are able to retire with automatic COLA adjustments to their annual annuity payments.

Figure 9

Prevalence of Automatic Cost-of-Living Adjustments in 2009:
Private Sector Defined Benefit Plans



Source: Hewitt Associates, LLC database of large employer plan specifications, covering over 1,000 major employers and including 80% of Fortune 500

It is sometimes suggested that even though their benefit levels may be more generous than those available in the private sector, public sector employees have contributed more than private-sector employees.

However, evidence was submitted to the Mayor's Pension Commission which showed that – as a percentage of payroll – contributions made by City employees may in fact be lower than those made by private-sector employees in general (once you consider the average contribution level made by employees into a 401k plan).

Figure 10

Replacement Ratios
City Employee Contribution Rate Comparison with Private-Sector Employees

	Fire	Police	Laborers and Municipal
Annual Contribution in Private Sector:			
- Annual SS Tax Rate	6.20%	6.20%	6.20%
- Average Annual 401(k) Deferral*	5.36%	5.36%	5.36%
Private-Sector Employee Contribution Rate	**11.56%**	**11.56%**	**11.56%**
City Employee Contribution Rate	**9.125%**	**9.00%**	**8.50%**
Annual Difference	2.435%	2.56%	3.06%
Equivalent % of Final Pay**	11.76%	12.36%	14.78%

*From 2008 Deloitte Consulting 401(k) Survey
**Annual difference accumulated to retirement, converted to an annuity and compared to final pay
Source: Deloitte Presentation to Annuity Benefits Committee, December 1, 2008 Meeting, p. 22.

Actuaries have estimated the level of annuity payments needed to enable a retired employee to maintain approximately the same life style level that he/she enjoyed when employed. This level is sometimes referred to as the "replacement rate." Evidence was submitted to the Mayor's Commission that a reasonable target replacement rate for City career employees would be in the range of 78%.

Figure 10 shows that if one takes into account the fact that City employees have contributed less in general than private-sector employees (e.g. firefighters have contributed 2.435% less than the average private-sector employee rate), and have therefore had the use of the money they did not have to contribute, the target replacement ratio should be adjusted. When this adjustment is made, it appears that career employees of the City have received pensions that exceed the adjusted target replacement ratio.

Figure 11

Replacement Ratios
30 Year Career Employee

	Fire	Police	Laborers and Municipal
Target Replacement Rate	78.00%	78.00%	78.00%
Contribution Equivalent Difference (from Figure 10)	11.76%	12.36%	14.78%
Adjusted Target Replacement Rate	**66.24%**	**65.64%**	**63.22%**
City Employee Actual Replacement Rate	**72.00%**	**72.00%**	**69.00%**
Excess over Target	5.76%	6.36%	5.78%
Accrual Rate Supported by Adjusted Target Replacement Rate	**2.30**	**2.28**	**2.20**

Source: Deloitte Presentation to Annuity Benefits Committee, December 1, 2008, p. 23.

Figure 11 shows that taking into account the lower contribution rate of City employees reduces their target replacement rate to something in the range of 63-66% (depending on the plan). The actual replacement rate of a 30-year City employee is above this target based on current benefit accrual rates. The implication of this analysis is that pension accrual rates for Chicago's career employees could be adjusted downward without precluding the employees from maintaining an adequate standard of living in retirement.

IV. THE CITY OF CHICAGO'S FINANCIAL CONDITION

The City of Chicago cannot afford its current pension plans.

According to the City, the operating budget for the current fiscal year (FY2010) is badly imbalanced – perhaps to the extent of $520 Million per year. Chicago has had to draw down on surpluses generated by its leases of the Skyway and of the parking meters to cover its anticipated expenses.

If the contribution requirements for the four Chicago pension plans were determined in accordance with the ARC, in FY2009 the contributions required from the City and the plan participants would have had to be increased by almost $600 Million. Deloitte has recently calculated that the 2012 annual funding shortfall is about $710 Million.

This means that Chicago's embedded annual budget deficit (without counting funds from borrowing or reserves, and using the ARC as the pension funding standard) is well in excess of $1 Billion.

In addition, Chicago is accumulating unfunded retiree health care obligations (OPEB liabilities as defined by the Governmental Accounting Standards Board). The current retiree health benefit structure expires in 2013. The Commission has not considered this issue in its deliberations, but if these obligations continue to accumulate, additional funding will ultimately be required.

Chicago does not now generate sufficient operating revenue to make these funding contributions; and no foreseeable combination of budget cuts or tax increases is likely to generate the additional funds that would be necessary to make them. Moreover, drastic service cuts or tax increases would create problems of their own – particularly in a time of economic recession.

It will become harder to make the necessary contributions in the future. As years pass, the "normal" cost of the pensions will increase. More important, as the unfunded liabilities increase, the amount that would be needed just to hold the unfunded level constant will also increase (8% times the growing unfunded liability).

If Chicago does not get control of its unfunded pension obligations now, the likelihood that it will be able to do so in the future will diminish, and the likelihood that the pensions will run out of money will increase.

Chicago cannot look to the State of Illinois to solve this enormous problem. The State has unfunded pension problems of its own – $76 Billion in unfunded pension liabilities and another $13.5 Billion in pension bonds/notes.

V. PROPOSALS FOR "RAMPING" OR MASSIVE BORROWING IN THE FORM OF PENSION OBLIGATION BONDS WOULD SIMPLY AVOID THE PROBLEM BY CONTINUING TO SHIFT IT OFF ONTO FUTURE BUDGETS AND FUTURE TAXPAYERS

At the heart of the *State's* current pension crisis is a continued pattern of avoided responsibility – of avoiding hard choices needed to balance our State budget, of putting off problems to the future … to some other Governor, and some other generation of taxpayers.

Mayor Daley and his top financial officers identified the problem of underfunded City pensions before the market crash of 2008, and created the Commission to try to deal with it. Unfortunately, the crash of 2008 aggravated the problem that was already there.

The problem of blame may be left to the historians. The practical problem faced by the City – as well as by organized labor, the business community, and other citizens – is what should be done now.

A. Creation of a new pension ramp

One alternative is to adopt a funding formula based on actuarial principles (ARC) and to "ramp up" to those levels. In other words – don't contribute based on ARC now because it would be too hard. Do it later, even though the ramp would mean shifting today's cost burden to the future.

Ramp or stair-step increases that take many years to move to full actuarial funding are just another way to shift today's costs to the future and to postpone making hard decisions. We have seen such ramps before – at the State level. As the ramp leads upward to an appropriate but uncomfortable level of funding, the State then changes the ramp – another postponement of bearing today's costs today.

Annual pension funding should be based on actuarial requirements, not what the State or the City thinks it can comfortably afford. Unwillingness in the past to make the difficult budget choices that would allow for full actuarial funding of the pensions is what got us to our current crisis. It cannot be allowed to continue.

B. Issuance of pension obligation bonds

Reliance on massive borrowing to get out of this fiscal mess would be like using a VISA card to buy stocks in the hope that increases in stock values would balance the budget.

Pension bonds are a terrible idea for a number of reasons:

1. Such borrowing would almost certainly be used (as Governor Blagojevich used it at the State level) as an excuse for continuing not to fund pension costs at an actuarially-correct level out of current revenues. And the mountain of unfunded pension obligations would just keep getting bigger.

2. Such an arbitrage strategy is enormously risky. One borrows at a lower rate of interest in order to invest the borrowed money in an investment that may draw a higher return. Private-sector arbitrageurs pursue such strategies with their own money subject to careful controls and limitations. Moreover, such arbitrage investment strategies involve taking on greater risk – as shown by the history of New Jersey's experiment with pension bonds. (After New Jersey issued $2.7 Billion in pension obligation bonds in 1997, the equity

markets into which these monies had been invested plummeted between 2000 and 2002 – leading to "negative arbitrage.")[10]

3. Such borrowing is also costly. Lawyers and investment bankers charge for their services incurred in issuing the bonds. The risk of "pay to play" is increased.

4. What happens when the borrowed money runs out? Would we issue still more bonds? How long can that go on?

Moreover, it may be illegal to put more money into the pension plans than permitted by law – either by (a) issuing pension obligation bonds, or (b) selling an asset and then dumping the proceeds into the pension funds. (See footnote 6, *supra*, at p. 5.) In the absence of special legislative permission, Chicago's only obligation appears to be that set forth in the funding statute: to pay into the funds the amounts specified by statute – neither more nor less. (This conclusion is consistent with the fact that when the Illinois legislature enacted special legislation to permit the sale or lease of Midway Airport, it included a provision permitting – but not requiring – any proceeds from a sale or lease of Midway Airport to be used in part to fund the pension plans [50 ILCS 615/20].)

Even if current Illinois law setting forth funding requirements were amended generally to permit additional funding, there is the larger reality that unless it receives something in return, the City should not use public funds for purposes other than to cover the costs of the City's operations or to satisfy the City's liabilities. Insofar as the City appears not to be the guarantor of the pension liabilities, transferring money into the funds – however that money is obtained (whether by pension bonds or asset sales or otherwise) – would no more be appropriate, in the absence of an appropriate *quid pro quo*, than transferring public money to some other private group or entity.

VI. ANY SOLUTION TO CHICAGO'S BUDGET AND PENSION FUNDING CRISIS WILL REQUIRE USE OF THE THREE KEY PENSION LEVERS (BENEFIT LEVELS, EMPLOYEE CONTRIBUTIONS AND EMPLOYER CONTRIBUTIONS)

A. Benefit Levels

Chicago's pension benefits must be reformed to reduce costs, as Chicago cannot afford the increasing rate of growth and unchecked taxpayer liability of current programs. The best alternative would be to create a new defined contribution (DC) plan for future

[10] For a few years after the issuance of the POBs, New Jersey's pension funds generated returns in the double-digits. But with the market decline of 2000, returns fell dramatically. Overall, from 1997-2005, the pension funds averaged an annual return well below the 7.6% that New Jersey promised in interest on the bonds, thus leading to "negative arbitrage" (over and apart from the transaction costs associated with issuing the bonds). (*BusinessWeek*, June 13, 2005)

application to both current and future employees. A new defined benefit (DB) plan would be a "second best" alternative – but would be better than the status quo.

Below are recommended elements to be included in a second-tier DB plan. Creating such a plan would reduce the $710 Million contribution shortfall in FY2012. Employees would still retain the values they have earned in their existing plans and would receive the benefits they have earned at the age at which they are qualified to do so under the present plans. However, those benefits would be "frozen" at the time of transition and all employees would begin in the new defined DB plan. Benefits for existing retirees would not be changed.

1. Creation of a less-costly defined benefit plan for all employees

The Civic Committee has recommended that the State of Illinois create either a new DC plan or a new DB plan with a less-costly tier of retirement benefits for both new and current employees – and with adjusted employee contributions. Chicago should do the same. This would require a change in State law, which should be done in collaboration with the State, Cook County and any other jurisdiction of local government requiring reform.

Opposition to the DC alternative is sometimes based in part on the fact that Chicago employees do not participate in Social Security. However, these employees have had the use of the money they would otherwise have been required to pay for Social Security benefits.

If opposition to the DC alternative makes it impossible, a new DB plan would be a second-best alternative. A new DB plan along these lines should be implemented prospectively for the four Chicago pension systems:

- Increase the unreduced retirement age to 67 with 10 years of service (63 with 10 years of service for Fire and Police) – to mirror current Social Security provisions – and the reduced retirement age to 62 (with 10 years of service).[11]

- Reduce the benefit accrual rate to 2.0% of pay.

- Limit COLA to the lesser of 1.5% (the COLA already applied to the retiree benefits of policemen or firemen born after 1/1/55) or ½ of the Consumer Price Index. Calculate COLA based on the originally granted annuity.

[11] Increasing the normal retirement age does not require an employee to remain in the City workforce until the designated age, but delays payment of benefits until that time.

- Calculate pension benefits solely on base salary up to the Social Security Covered Wage Base (presently $106,800). Calculate final average salary on the average of the highest consecutive eight years out of the last ten years.

- End pension abuses, such as double-dipping.

The above prospective changes in pension benefits should be accompanied by adjustments to employee contribution levels (discussed below).

The pension reforms enacted in March of 2010 by the General Assembly apply a second-tier DB plan to *future hires* who participate in Chicago's laborer and municipal employee pension plans; but police and fire funds were exempted across the State. Current employees in all of the City's four pension funds are thus unaffected by the reforms. The reforms for future hires are similar to those described above in that they increase the unreduced retirement age to 67, cap the salary used for pension calculations at the Social Security Covered Wage Base, calculate final average salary on the highest consecutive eight years out of the last ten years and reduce cost-of-living adjustments. However, they leave both the benefit accrual rate and the employee contribution rate unchanged.

2. The Illinois Constitution permits reforming the current pension programs to include *current* employees as well as future hires.

The Pension Protection Clause of the Illinois Constitution provides:

> "Membership in any pension 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." Ill. Const., art XIII, #5.

Representatives of employees have suggested that this clause does more than protect an employee's contractually-vested rights. They have argued – or assumed – that provisions in pension plans could not be altered prospectively if the effect were to reduce benefits which might be accrued in future years. Accordingly, they have argued that Chicago's current pension benefits could not be reformed prospectively to make them less costly to the City.

The 1970 amendments to the State's Constitution were intended to grant contractual status to participation in public pension plans. Such status would mean that accrued rights would have contractual protection. Such status would not mean that provisions in pension plans might not be changed prospectively to make them less expensive – so long as rights accrued prior to the change are fully protected. The "benefits" which "shall not be diminished or impaired" are the contract rights vested under the "enforceable contractual relationships" protected by the Constitution. (See Appendix B.)

Under pressure of economic circumstances, many plans available to employees working in the private sector have been adjusted prospectively without interfering with vested rights. Such incidents of prospective adjustment have not been deemed to violate employee contractual rights and are allowable under IRS and ERISA rules and regulations.

The second-tier pension benefits proposed above should thus be implemented prospectively for *current active* employees as well as *new* employees. Prospective implementation can and should be done in a way that fully protects all employee vested contract rights.

Prospective implementation of a second-tier of benefits (such as that outlined above) for only *new* Chicago employees would mean relatively little in current savings to Chicago, and very little in reduced pension costs over the next several years under the current funding policy of the City. This is because the savings would only be recognized as – and to the extent – that new workers replace current workers in the Chicago work force.

However, prospective implementation of a second-tier of benefits for *current* employees would have an immediate and very substantial impact by (a) adjusting downward the estimated amount of unfunded liability, (b) prospectively adjusting downward the annual amounts of contributions required to cover "normal" pension cost, and (c) prospectively reducing the amounts needed in years to come to cover the 8%-per-year growth in the unfunded liabilities.

At the State level, prospective implementation of second-tier benefits for current employees is estimated to reduce the current unfunded pension liability by $20 Billion or more.

At the Chicago pension fund level, such prospective implementation for current and future employees would reduce the current unfunded pension liability by approximately $4.4 Billion and current annual costs by approximately $400 Million.

B. Contributions – Employee and Employer

The second element of reform – increasing annual funding of the pensions – should be done in accordance with actuarial standards (to the level of the annual required contribution, or ARC), rather than some notion of what the City can afford to pay. The Mayor's Commission agreed with this recommendation (Commission to Strengthen Chicago's Pension Funds Final Report, *Volume 1: Report and Recommendations,* Recommendation #3). Otherwise, the City risks recreating in the future the underfunding problems that have arisen over the past decade.

Any increased contributions necessary to attain the ARC should be shared by the City and employees. If both new and current active employees participate in a prospective second-tier plan, the ARC would be significantly reduced since both the annual normal pension cost and the unfunded pension liability would be reduced.

If the current Chicago pension plans are not frozen or amended prospectively for *current* employees, such employees should be required by law to cover a more significant share of the annual contribution needed to attain the ARC. The City would then be responsible for the remainder of the necessary increase in contributions. Under this scenario, the ARC would remain close to its current level in the short-term, since the unfunded liability would be unaffected by benefit reforms and the normal cost would only be reduced as new employees were hired.

C. Asset Pooling

When second-tier plans are adopted for *new* workers, if the plans are reasonably well funded, there appears to be no problem with pooling the assets of the old and new (second-tier) plans. Such pooling does not put at risk the contributions made by the new employees who will participate in the new or second-tier plans.

But when the pension plans are as underfunded and at risk as the Chicago pension plans, it could well be unfair to pool the contributions of the new employees in the second-tier plans with those in the old plans. In effect, this would permit the plan administrators to use the contributions of the new employees to pay out benefits to the employees in the old plans, rather than to build values that would be available when the time comes for the new employees to start to receive pensions.

This problem would be avoided by structuring the second-tier plans as *defined contribution* plans, since the contributions of each new employee would be cordoned off and used entirely to build retirement programs for the new employees. A decision to continue with the defined benefit approach would underscore the need to separate the asset pools, and not to use contributions of the new group of employees to pay out benefits to the employees participating in the current plans.[12]

[12] One might ask: isn't the problem identified here one that already exists *within* the structure of the existing pension plans? Aren't contributions of employees hired later, and younger, being used to pay benefits to the older group of employees as they retire? The answer is that when plans are significantly underfunded, there is clearly potential unfairness here as well. Where assets are already commingled, there may be no good way to avoid the problem. But it clearly should be disclosed. The administrators of the current plans should make disclosure to all their members – particularly the new employees and those farther from the point of retirement – that contributions from these younger members are being or may be used (or assets acquired with those contributions are being or may be used) to fund pensions for retirees or older employees, rather than to build up asset values that will be available for their own retirement when the time comes.

CONCLUSION

Chicago's four pension plans are badly underfunded. Two things are needed: reform and improved funding.

Reform is needed as to both current and new employees because the present plans provide benefits that are far more generous and costly than those available in the private sector, and because Chicago cannot afford to continue to incur these costs.

At the same time, Chicago's retirees and current employees should participate in retirement plans that are adequately funded. The ultimate unfairness – to Chicago's retirees and current employees – would be if nothing is done and the pension funds run out of money. The Firemen's fund is in the worst shape. If nothing is done, it will run out. The only question is when. The effect on retirees and workers nearing retirement would be disastrous. It would be in no one's interest if any of the pension plans were to run out of money.

The reforms can and should be accomplished in a way which is fully consistent with the Illinois Constitution and does not diminish or reduce any benefits which Chicago's retirees or employees have earned.

The longer we wait to undertake these two tasks – reform and improved funding – the more difficult and more costly they will be.

It would be best to start now.

APPENDIX A

The Civic Federation

177 North State Street, Suite 400, Chicago, IL 60601 • 312.201.9066 fax 312.201.9041 • www.civicfed.org

March 18, 2010

Mr. Dana R. Levenson
Co-Chairman, Commission to Strengthen Chicago's Pensions
c/o Royal Bank of Scotland
71 S. Wacker Drive
Chicago IL 60606

Mr. Gene R. Saffold
Co-Chairman, Commission to Strengthen Chicago's Pensions
c/o City of Chicago
121 N. LaSalle
Chicago IL 60602

Dear Chairman Levenson and Chairman Saffold:

Thank you for the opportunity to comment on the final report of the Commission to Strengthen Chicago's Pension Funds. Your leadership has helped develop meaningful consensus of the Commission regarding the size of the problem and the direction of potential solutions. I also commend the work of the staff and actuaries whose models have been invaluable in illustrating the effects of different proposals.

The Civic Federation is strongly concerned that many of the report's recommendations do not go far enough. The severity of the City's pension crisis cannot be overstated and no small changes will be adequate to the task of restoring the funds' fiscal health. Major benefit changes and contribution increases are required. The risk of these funds running out of money to pay benefits is now very real.

The Civic Federation makes the following specific recommendations:

1. **Reduce pension benefits for both new employees and prospectively for current employees**, as described in **Scenario 2-All** (see Appendix 3). This includes using an 8-year final average salary, a 2.0% benefit accrual rate, unreduced retirement at age 67 and ten years of service for members of the Municipal and Laborers' funds and at age 63 and ten years of service for members of the Police and Fire funds, COLA at the lesser of 1.5% or CPI with simple interest, and limiting pensionable salary to the Social Security Covered Wage Base ($106,800 in 2010).
2. The situation is so severe that even with these benefit reductions, **both the City and the employees will have to make additional contributions**. We recommend, as does the Commission, that these contributions be actuarially-based. The Commission report uses a 60:40 ratio between employer and employee contributions but we recommend a **50:50 ratio** where the City and employees would split the cost of contributions, as do employers and employees participating in the Social Security system.
3. The City's annual contribution must increase immediately by several hundred million dollars. The Civic Federation recommends that the **City make several**

hundred million dollars worth of cuts to services starting in FY2011 in order to free up resources to pay the required pension contribution, **otherwise the size of the tax increase needed will be massive**. For years the City has failed to contribute amounts needed to keep the funds healthy, so dramatic and immediate shifts in the City's spending priorities are needed.

4. **The pension funds should be consolidated.** The City should not have four separate pension funds for its employees. The Civic Federation recommends that either the four funds be consolidated into a single fund, or that the Municipal and Laborers' funds be merged with the Illinois Municipal Retirement Fund and the Police and Fire funds be merged into a single Chicago Public Safety fund.[1]
5. The Civic Federation recommends that the **composition of the pension fund boards of trustees be revised** in three ways. The balance of employee and management representation on the boards should be changed so that employees do not hold the majority of seats. A tripartite structure should be created that includes independent citizen representation on the board. Finally, financial experts should be included on the pension boards and financial training for non-expert members should be required.[2]

We do not make these recommendations lightly, but we believe that the severity of the pension crisis demands that these actions be taken. This crisis has built up over years of making pension enhancements and failing to adequately fund the plans. The pensions promised to public employees are now much richer than what most private sector employees and taxpayers can expect to receive. Yet residents of Chicago will have to bear either service cuts or tax increases in order to save the pensions of these public employees. Major sacrifices must be made by all.

Sincerely,

Laurence J. Msall

Laurence Msall

[1] See the Civic Federation's *Status of Local Pension Funding FY2008: An Evaluation of Ten Local Government Employee Pension Funds in Cook County* at http://www.civicfed.org/civic-federation/publications/fy2008statuslocalpensions

[2] See the Civic Federation's *Recommendations to Reform Public Pension Boards of Trustees in Illinois* at http://www.civicfed.org/civic-federation/publications/recommendations-reform-public-pension-boards-trustees-illinois.

APPENDIX B

Pension Reform Analysis

The Pension Protection Clause of the Illinois Constitution provides: "Membership in any pension 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." Ill. Const., art. XIII, § 5. As the Supreme Court recognized, the "primary purpose" of the clause was "to eliminate any uncertainty as to whether state and local governments were obligated to pay pension benefits to their employees." *People ex rel. Sklodowski v. State*, 182 Ill. 2d 220, 228 (1998). Prior to the 1970 Constitution, when a pension plan was mandatory, "the rights created in the relationship were considered in the nature of a gratuity that could be revoked at will." *Id*. The Pension Protection Clause changed that, "mak[ing] participation in a public pension plan an enforceable contractual relationship [that] demands that the 'benefits' of that relationship 'shall not be diminished or impaired." *Id*. at 228-29.

An increasingly important question is whether a *prospective* diminishment in pension benefits — meaning a diminishment that applies only to an employee's future service, not to benefits already accrued from the employee's prior service — causes a pension benefit to be "diminished or impaired." The answer is No. Four years after the 1970 Constitution, the Supreme Court held that "the purpose and intent of the constitutional provision was to insure that pension rights of public employees *which had been earned* should not be 'diminished or impaired' … ." *Peters v. City of Springfield*, 57 Ill. 2d 142, 152 (1974) (emphasis added); see also *People ex rel. Ill. Fed'n of Teachers v. Lindberg*, 60 Ill. 2d 266, 271 (1975) (reiterating standard from *Peters*). Thus, the only pension benefits protected from diminishment are those "which had been earned" at the time the pension scheme is altered. Pension benefits earned in the past cannot be reduced, while benefits that the employee hopes to earn in the future can be reduced.

The Attorney General considered this very issue in Atty. Gen. Op. No. S-1407, 1979 Ill. Atty. Gen. 9 (Jan. 10, 1979). In Public Act 80-841, the General Assembly amended the manner in which the Pension Code calculated an employee's pension. Prior to the amendment, the pension was based on "final average compensation," meaning the actual monthly pay during any four of the employee's last ten years of service, which usually was the last four years, when the employee's wages generally were the highest. The amendment provided that, for purposes of calculating "final average compensation," the employee's salary for the last 12 months of the four-year period could not exceed the "final average compensation" by more than 25%.

The Attorney General recognized that the amendment, "by changing the way in which State employees' compensation is considered for pension calculation purposes, may result in lower pensions for some employees than they would have received otherwise." *Id*. at 10. For example, if "a State employee happened to receive $9,000 each of the first three years and then was appointed to a $13,000 position the fourth year," the employee's "final average compensation" would have been $10,000 under the former system, but about $200 less under the amendment. *Id*. at 11. The question was whether the amendment diminished pension benefits under the Pension Protection Clause.

In answering that question, the Attorney General focused on the above-quoted passage from *Peters*, which makes clear that the Clause was designed to protect only those pension rights "which had been earned." *Id*. at 13. Applying that principle, the Attorney General concluded that "applying the [amendment] to pay received before January 1, 1978," the amendment's effective date, would violate the Clause. *Id*. By contrast, the Attorney General stated that the amendment "may be applied only to earnings received after" the effective date.

The lesson of *Peters*, then, is that the Pension Protection Clause prohibits state and local governments from reducing pension benefits earned in prior years, but permits state and local governments to reduce pension benefits an employee may earn in the future, benefits that have not yet accrued. This conclusion is in accord with the underlying premise of the Clause, which was to "create a contractual right to benefits." *Sklodowski*, 182 Ill. 2d at 233. "Statutory pension rights cannot be altered, modified, or released except in accordance with usual contract principles," meaning that "the constitutional protection afforded public pensions extends as far as the pension rights conferred by statute and contract." *Smithberg v. Illinois Mun. Retirement Fund*, 306 Ill. App. 3d 1139, 1143 (1999). Contract law does not permit one party to deprive its counterparty of fruits of the contract that have already been earned. But contracts, and statutes, are not frozen in place for all eternity, and can be amended to alter the parties' relationship on a prospective basis. See *Peter*, 57 Ill. 2d at 151-52 (municipality may lower retirement age from 63 to 60 even if effect is to reduce pension benefits of retirees); *Higgins v. Sweitzer*, 291 Ill. 551, 554 (1920) ("the right to prospective salary of an office or position is not a property right"). By adding the Pension Protection Clause to the 1970 Constitution, the Framers intended to adopt those very principles to govern the rights and obligations inherent in public pensions.

Supplemental Pension Reform Analysis

The Pension Reform Analysis we submitted several months ago addressed the text of the Pension Clause, as well as case law and an Attorney General opinion issued shortly after adoption of the 1970 Constitution. While certain other Illinois decisions have addressed the Pension Clause, we believe those decisions do not undermine, and in fact are consistent with, our bottom-line conclusion that because the purpose of the Clause was to create a contractual right to pension benefits, statutory pension rights are not frozen in place for all eternity and may be amended to alter the parties' relationship on a prospective basis — meaning to alter benefits to be earned in the future.[13]

We understand that some have raised questions regarding those other decisions, particularly *Buddell v. Board of Trustees*, 118 Ill. 2d 99 (1987), and *Kraus v. Board of Trustees*, 72 Ill. App. 3d 833 (1979). The holdings of those cases are consistent with the principle, set forth in *Peters v. City of Springfield*, 57 Ill. 2d 142, 152 (1974), that a prospective diminishment in pension benefits does not violate the Pension Clause. In *Buddell*, the benefit at issue – the right to purchase military service credits – was earned on the effective date of the 1970 Constitution. And in *Kraus*, the benefit at issue – the right to have pension benefits calculated based on the salary attached to his rank at the time of retirement, as opposed to the time he went on disability – had been earned in the past, as the plaintiff began work 17 years prior to the statutory amendment and went on disability six years prior to the statutory amendment at issue.[14]

Indeed, *Kraus* explicitly recognized that the Pension Clause would not prohibit any of the following actions: (i) reducing work hours or salary on a prospective basis; (ii) increasing employees' contribution rates to equalize their contributions with those of other employees; (iii) requiring the employee to agree, for consideration, to accept a reduction in benefits; (iv) conditioning COLAs or other salary increases on the employee's agreement that they not be regarded as salary for pension purposes. *Kraus*, 72 Ill. App. 3d at 849-50. All this can be accomplished legislatively. The General Assembly could provide, on a prospective basis, that COLAs are not counted for pension purposes. It also could increase contribution rates, again prospectively. And the General

[13] Cases addressing whether the Pension Clause requires a specific level or mechanism for pension funding are inapposite as regards the contour of the right to receive benefits protected by the Pension Clause. *See, e.g., People ex rel. Illinois Federation of Teachers v. Lindberg,* 60 Ill. 2d 266 (1975); *McNamee v. State,* 173 Ill. 2d 433 (1996); *People ex rel. Sklowdowski v. State,* 182 Ill. 2d 220 (1998); *Houlihan v. City of Chicago,* 306 Ill. App. 3d 589 (1999).

[14] Other decisions that invalidate actions diminishing pension benefits already accrued for the employee's prior service, which likewise do not undermine the principle that the Pension Clause permits a prospective diminishment in pension benefits, include *Felt v. Board of Trustees,* 107 Ill. 2d 158 (1985), and *Miller v. The Retirement Board of Policemen's Annuity,* 329 Ill. App. 3d 589 (2002)

Assembly could pass a law conditioning future employment upon an agreement to prospectively alter pension benefits or formulas – in that scenario, the consideration for a prospective reduction in benefits would be the State's agreement to continue employing the employee.

Thus, our conclusion remains as it was before: the Illinois Constitution does not prevent Illinois pension reform applicable to current state employees or other members of state pension funds, provided that all contract rights vested by current employees for past service – all rights earned up to the time the pension reforms are implemented – are protected.