COGFA STUDY DRAWS NO CONCLUSIONS REGARDING INCREASING MUNICIPAL PENSION COSTS.
(A RESPONSE TO THE IML)

The Illinois Public Pension Fund Association (IPPFA) offers this response to the IML Legislative Update commentary on the COGFA report:

The IML Legislative Update, published March, 2010, provides a commentary on the recently issued report by the Illinois Commission on Governmental Forecasting and Accountability. (COGFA) The COGFA report is required by a recent change in the Illinois Statutes reassigning the responsibility for the preparation of this report from the Department of Insurance to the Commission.

The COGFA report presents a compilation of data through 2008 culled from the Downstate Police and Firefighter Pension Funds Annual Statements submitted to the Department of Insurance. The contents of the report have not changed since its last publication which summarized the results of the Downstate Police and Firefighter Pension Funds Annual Statements filed with the Department of Insurance for the 2005 and 2006 years. Unfortunately neither has the rhetoric of the Illinois Municipal League (IML).

The IML Legislative Update is entitled "COGFA Study shows Municipalities Struggling to Keep Up with Growing Pension Costs". It states that "*the COGFA report provides insightful information about the factors affecting the fiscal condition of ten municipal public pension funds*." and presents "*an analysis of the several factors causing the fiscal deterioration among the pension funds*" It does neither. The IML statments are simply another diversion from the true reasons why municipalities are struggling to keep up with increasing pension costs—**a poorly designed actuarial funding system and years of fiscal neglect by many municipalities to make the proper contributions.**

The COGFA report is solely statistical in nature. It presents charts and selected detailed information for police and fire pension funds in 5 communities. No details are presented for the other 342 police pension funds or 309 firefighter pension funds. **Absolutely no conclusions are made by COGFA in the report.** There is a simple reason for this. It is not COGFA's responsibility to comment on the report, it is their responsibility simply to present the results.

Additionally the report contains actuarial statistics regarding the contribution increases from 2004 through 2006 resulting from three pension laws passed over 15 years ago. **Once again, there are absolutely no conclusions nor interpretations made by COGFA in the report.**

It remains an undisputed scientific fact that the statutory change passed by the General Assembly in 1993 to alter the actuarial funding methodology used to calculate the amortization of the unfunded liability is the largest contributing factor to the contribution increases during the past 17 years. The second most influential action was a conscious decision by many municipalities to simply follow the State's lead and to contribute less than the statutory minimum contribution. This approach has led to Illinois' position as the national leader in maintaining unfunded public retirement systems.

The IML contends that its original 2007 study – "A Fiscal Analysis of the Downstate Police, Fire and IMRF Pension System" cast an initial light on "what" was happening to the financial condition with the municipal public safety funds—namely a rapid deterioration in funding levels and an accumulation in unfunded liability and now states that "the value of the COGFA study is that it provides the best analysis to date of "why" this financial deterioration is occurring".

The original IML study has already received our response "A Fiscal Analysis of the Downstate Police, Fire and IMRF Pension System—A Critical Commentary" available from the Illinois Public Pension Fund Association, www.IPPFA.org. That response clearly demonstrates our position as to the "what" was happening and concludes with the following:

> "The purpose of this response is not to place blame upon or point fingers at the sponsoring municipalities. We agree with the premise that for any complex phenomenon there are likely a multitude of reasons. We do however, disagree that the fiscal problems being experienced by the problematic state-funded plans are also in existence within the Downstate Police and Fire Pension Systems. On average the State funded pension Plans are approximately 60% funded, while the Downstate Police and Fire plans are close to 70% funded.
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> We further agree that benefit improvements and poor investment returns may also be contributory factors to the current situation."

In a similar manner, we are not disputing the statistics presented in the COGFA report. We are only disputing the IML's misreporting of the "*conclusions*" reached by COGFA— as there simply are none.

WHAT THE COGFA STUDY REVEALED

According to the IML the COGFA study reveals the following:

- Increasing employer contributions are not reversing the financial decline
- Insufficient employer contributions are not the primary cause of underfunding
- Poor investment returns are driving much of the unfunded liability
- Benefit enhancements have significantly increased fire pension fund costs

Let's look at each of these "revelations"—

Conclusion 1: **Increasing employer contributions are not reversing the financial decline**

As indicated earlier, this is correct and is expected as a result of the funding method change in 1993. To reiterate from our original commentary—

> In 1993, the funding statute was modified to change the method of amortization of unfunded actuarial liabilities. The method change was to determine the amortization amount as a "level percentage of payroll" rather than as a "level dollar amount" over a 40-year schedule beginning in 1993.
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> Studies by independent actuaries and DOI staff at that time calculated that this change in methodology would result in the following outcome. **<u>If every actuarial assumption used in funding were exactly realized (a virtually impossible scenario), then the unfunded actuarial liability would increase 300% in 12-years (simply because of the lower payments) and then would begin its decline to 0% by 2033.</u>**
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> In other words, a pension fund with an unfunded liability of $10 million in 1993 which followed the DOI contribution schedule each year, earned exactly 7% interest on its funds, paid out exactly the benefits which were actuarially expected and hired no new participants would find itself in 2005 with a $30 million unfunded liability
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> Of course, the revised schedule is not a level dollar schedule as in the prior statute, so municipalities were also advised that the annual payment would grow 5½% per year to mirror the expected growth in payroll.

However, municipalities seldom treat contributions to the Downstate funds in the form of contribution percentages. Despite repeated attempts by the DOI and the independent actuaries to express the statutory funding requirements as a percentage of payroll, it is the rare community which calculates the tax levy as a percentage of payroll cost. Instead the amount is viewed, budgeted and contributed as a flat dollar figure unrelated to payroll.

In the recent Legislative Update, the IML continues to express comparisons in amounts of dollars instead of as a percentage of payroll, so lets look at their charts more properly, with the employer contribution expressed as a percentage of payroll.

FIREFIGHTER PENSION FUNDS (Table A)		
City	**Employer Contribution Increase (2004-2008)***	**Funding Change (%) (2004-2008)**
Bellwood	8.47%	-21.86%
Arlington Heights	10.97%	-6.69%
Champaign	15.58%	-1.32%
Springfield	14.31%	-24.65%
Wilmette	10.88%	-11.47%

*expressed as a percentage of payroll

POLICE PENSION FUNDS (Table B)		
City	**Employer Contribution Increase (2004-2008)***	**Funding Change (%) (2004-2008)**
Bellwood	32.69%	-.6%
Arlington Heights	3.77%	4.29%
Champaign	6.29%	10.76%
Springfield	9.28%	-14.66%
Wilmette	4.91%	-14.54%

*expressed as a percentage of payroll

What conclusions can be drawn from the foregoing charts? Absolutely nothing other than there has been a modest increase in the contribution expressed as a percentage of payroll over the period from 2004 - 2008. One can draw no statistical conclusions concerning the correlation of the funded percentage to the contributions. Also, it should be noted that the Bellwood Police information is completely flawed as the contributions made for this fund have varied from a low of $90,429 in 2004 to $2,453,427 in 2006 and back to $851,797 in 2008. It is included here simply because we are reporting the same information as the IML.

Conclusion 2: Insufficient employer contributions are not the primary cause of underfunding

The IML commentary indicates that the COGFA report suggests that municipal contribution levels are not the primary cause of the growing unfunded liability among the public safety pension funds. This is factually incorrect and is clearly unsupported by the statistics presented.

Since the COGFA report does not indicate the amounts of the actuarially required contributions, no proper comparison of the required contributions to the contributions actually made can be analyzed. Nonetheless, we feel confident in stating that the

Bellwood Police statistics reported individually in the COGFA report in Chart 15 strongly indicate an unlikelihood that the municipal contributions actually made bear any relationship to the actuarially calculated required contributions.

Furthermore, we continue to believe, absent evidence to the contrary, that insufficient employer contributions are a leading cause of the current underfunding.

Conclusion 3: Poor investment returns are driving much of the unfunded liability

The IML commentary states as follows: "Lower than ***expected*** investment returns were one of the top two drivers of unfunded liability among seven of the ten police and firefighter pension funds. Actual investment return in each pension fund underperformed the ***actuarially assumed rate of return*** for each fund for the years 1999 through 2008." The DOI calculations during the 1999-2008 years used an assumed investment rate of return of 7%. The IML report indicates that the average assumed rate of investment return for the independent actuaries was 7.43%.

We do not dispute the numbers. But, unfortunately, this is a 9-year period analysis. Perhaps we should instead examine a different 9-year period, the period from 1980 to 1988, to determine if the assumed rates of return during that period of growth exceeded the actual rates of return at that time. The DOI calculations during the period 1980-1988 used a 6.50% assumed rate of return despite interest rates on money market accounts yielding over 15%.

The actuaries who have performed the contribution calculations no doubt have made note of this in keeping with the Actuarial Standards of Practice regulating the profession. The Actuarial Standards call for analysis over the long term and a 9-year period is simply not sufficient for conclusions.

The IML is fully aware that, at the municipalities' behest, the actuarial assumptions used by some actuaries selected by the municipalities rather than the funds themselves are extremely liberal. This is a conscious choice to reduce the contribution levels to meet budgetary needs. This is not a fund problem, it is a municipal problem and a driving force behind the ultimate increase in contribution levels.

Finally, it is foolish to compare the Downstate funds with their restricted investment rules to the IMRF which has unlimited authority over its investments This is a false argument.

Conclusion 4: Benefit enhancements have significantly increased fire pension fund costs

Once again the COGFA report is silent on this. One must use perverse logic to reach the above conclusion. Benefit increases are never one-sided. Every benefit increase is actuarially studied for cost increase before General Assembly approval. Firefighters' and Police contribution levels increase when there is a serious increase in benefit cost.

The basic system is designed so that the total cost of the pension program over the long term is borne one-third by the participants and two-thirds by the municipality. This ratio is constant and has held since the early 1980's when the funds were formally codified.

THE PENSION FUNDING DEBATE

But, as we all agree, finger pointing will not solve the continued problem of escalating pension contributions. The IPPFA has four immediate suggestions to address this problem.

1. A change in the actuarial funding method to return to level dollar amortization.

2. A change to a 30-year rolling open amortization period.

3. A statutory change to provide clear enforcement to require the municipality to contribute the calculated actuarial contribution requirement

4. A loosening of the investment restrictions placed upon the Downstate funds.

1. <u>A change in the actuarial funding method to return to level dollar amortization</u>

A return to a controllable actuarial cost method will stabilize municipal contributions as they were in the 1980's. The current level percentage of payroll method defers the larger contributions to future generations of taxpayers. It is a method which is designed to produce an increasing cost for funding and it is illegal in some states because of its uncontrollable results.

2. <u>A change to a 30-year rolling open amortization period</u>.

Use of a rolling open amortization period will not produce a fully funded pension program, but, in a continuing entity such as a municipality, full funding is actually unnecessary. Cash flow requirements should be able to be met with less than 100% funding,

3. <u>A statutory change to provide clear enforcement to require the municipality to contribute the calculated actuarial contribution requirement</u>

Failure to make contributions is, in our opinion, a leading cause for the current underfunding. Since the IML believes the contrary, we can find no reason that they would be opposed to this legislative change.

4. <u>A loosening of the investment restrictions placed upon the funds</u>

With the new requirements concerning the education of all Pension Trustees, we believe that a loosening of the strict investment restrictions should be examined for the Downstate funds. We agree that the current pension underfunding is partially a result of market fluctuations and better educated fiduciaries will be more responsive in the future.

The IPPFA looks forward to a continued dialogue on the issues affecting the Downstate Police and Firefighter Pension funds and we welcome the opportunity to work more closely with the municipal organizations in helping to control the municipal contribution requirements and to protect the pensions for the uniformed public safety personnel.