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Attorney No. 89500

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

JAMES MCNAMEE, et al., Plaintiffs,	)	
vs	)	No. 94 CH 884
THE STATE OF ILLINOIS; JIM EDGAR, Governor, STEPHEN F. SELCKE, Director, ILLINOIS DEPARTMENT OF INSURANCE Defendants.	)	

AFFIDAVIT IN SUPPORT OF THE PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

Arthur H. Tepfer, by certification, states as follows:

(1) My name is Arthur H. Tepfer and I am a principal in the actuarial firm of Tepfer & Spitz, Ltd. I have spent more than twenty-five years in the actuarial profession.

(2) I am a member of the American Academy of Actuaries. I am an Associate of the Society of Actuaries and an Associate of the Society of Actuaries and an Enrolled Actuary.

(3) A statement concerning my professional background is attached to this affidavit.

(4) I am familiar with the funding provisions of the Illinois Pension Code, particularly Section 3-127 which deals with funding police pensions.

(5) The amendment to 40 ILCS 5/3-127 of the Illinois Pension Code defers municipal contributions to police pension funds in the State of Illinois for later and later periods by using negative amortization of unfunded liabilities.

(6) In the early years of this new funding method, police pension funds will be detrimentally affected because municipal contributions will be insufficient to pay the interest on the funds' unfunded liability, let alone reduce the outstanding principal. This "non-funding" will cause these pension fund liabilities to increase dramatically.

(7) The new funding method under 5/3-127 does not build up reserves as fast as the previous statutory provision did and thus produces less assets for the pension fund. As a result the amended provision provides a funding mechanism that is less secure than the former funding method.

(8) Over the long term, total contributions to police pension funds would have been larger under the prior language of 5/3-127.

(9) The amended 5/3-127 has lengthened the period over which the unfunded accrued liability is to be amortized, but more importantly, changes the method of computation of the annual contributions made to each police pension fund.

(10) The amended 5/3-127 permits the amortization of contributions as a level percentage of payroll, rather than as a level dollar payment which results in an initial substantial increase in the unfunded liabilities of police pension funds.

(11) As a result of the above, the amendment to 5/3-127 substantially impairs and diminishes the pension benefits to participants and beneficiaries of Illinois police pension funds.

(12) I recently researched and prepared an article entitled: Funding Implications of the New Pension Law, a copy of which is contained in this Appendix.

ARTHUR H. TEPFER

VERIFICATION BY CERTIFICATION

Arthur H. Tepfer states under penalties as provided by law pursuant to Section 1-109 of the Code of Civil Procedure, 735 ILCS 5/1-109, that the statements set forth in this affidavit are true and correct, except as to those matters stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he believes the same to be true.

ARTHUR H. TEPFER

ARTHUR H. TEPFER

Mr. Tepfer is a Principal and Actuary for Tepfer & Spitz, Ltd., an actuarial, administrative, and employee benefit consulting firm in Northbrook, Illinois. Prior to forming Tepfer & Spitz, Ltd. in 1990, Mr. Tepfer was Midwestern Managing Director of the Actuarial and Employee Benefit Practice for Laventhol & Horwath. During recent years, Mr. Tepfer has held positions as Senior Vice President of Hay/Huggins Company, Inc. and was President of his own firm.

With more than 25 years in the actuarial profession, Mr. Tepfer has spent the last 21 years as a consulting actuary. Before forming his own company in 1981, he was associated with Jaffe & Associates, Ltd. and the Martin E. Segal Company. He is a Member of the American Academy of Actuaries, an Associate of the Society of Actuaries, and an Enrolled Actuary. He holds a B.A. degree from Rutgers University, New Brunswick, New Jersey.

During his career, Mr. Tepfer has served as a consultant to the employee benefit plans of many Fortune 500 corporations, public retirement and large collectively bargained multi-employer plans. In his current capacity, his primary responsibility is developing new business, as well as consulting in employee benefits to small and mid-sized companies. Additionally, he has developed a national reputation in providing expert testimony with regard to actuarial matters in matrimonial dissolutions, loss of income situations, and ERISA litigation.

Mr. Tepfer has lectured on pension matters at many professional actuarial meetings and has conducted seminars in association with Harvard University, the Chicago Association of Commerce and Industry, the Chicago Bar Association, the Illinois Judges Association, and the Illinois CPA Foundation. He regularly lectures to the annual Enrolled Actuaries Meeting and the American Society of Pension Actuaries Meeting in Washington D.C. on pension matters and expert actuarial testimony. As part of the Chicago Bar Association Continuing Legal Education Committee, he has lectured to the matrimonial section in a recent seminar regarding expert testimony in marital dissolutions. In April 1987 he served as a faculty member and conducted a seminar sponsored by the Society of Actuaries on "Actuarial Involvement in Litigation." He currently serves on the Society of Actuaries Education and Examination Committee for Actuarial Testimony.

Mr. Tepfer regularly publishes for many professional journals and, in the area of actuarial litigation support, is co-author of an article in the ISBA Family Law Newsletter published in June, 1980 entitled "The Value of Defined Benefit Pension Benefits in Marriage Dissolutions." He is also the author of "Valuing Defined Benefit Plans," an article appearing in the Spring, 1983 issue of Family Advocate magazine, published by the ABA Family Law Section.

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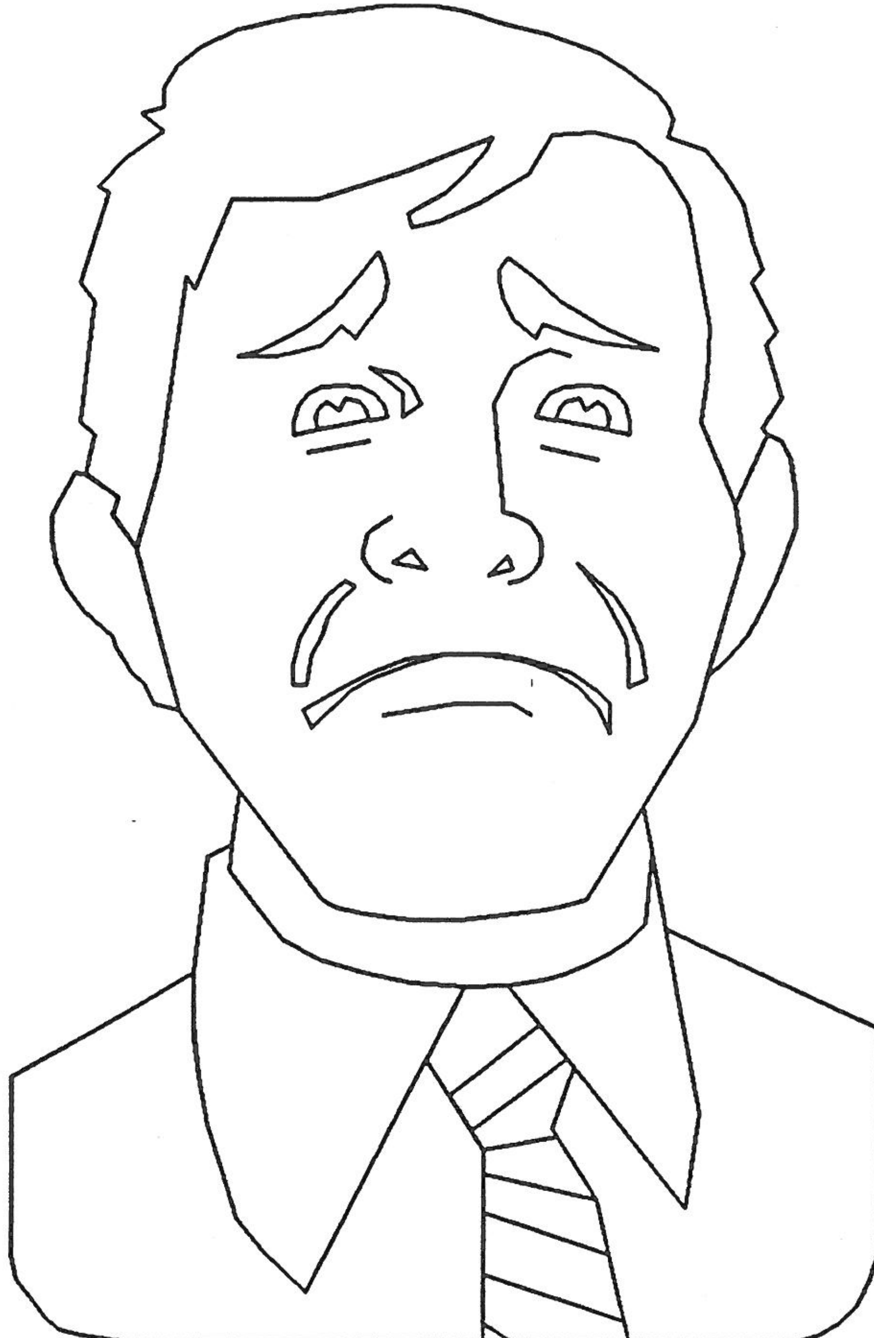
DOWNSTATE POLICE AND FIRE PENSION FUNDS

FUNDING IMPLICATIONS OF THE NEW PENSION LAW

BY ARTHUR H. TEPFER, A.S.A., M.A.A.A.
Actuarial Consultant to the Illinois Police Pension Fund Association



New pension legislation recently signed by Governor Edgar provides a number of improvements to the Downstate Police and Fire Pension Funds, but unfortunately contains language which could undermine the entire funding operation of the systems.

FUNDING THE PENSION PROGRAM

Funding of police and fire pension programs is required under Illinois Law to preserve benefit security for the participating uniformed personnel and to insure that the cost of the pension program is adequately budgeted and paid for by the current generation of municipal taxpayers. Funding a pension plan consists of two pieces -- an annual *normal cost* and a payment on the *unfunded accrued liability.*

In simple terms, pensions which are earned each year by members are funded through the payment of a normal cost. Benefit changes, gains and losses, and prior service pensions which have been earned in past years are segregated into an accrued liability and funded separately each year as part of the total cost of the program. The purpose of this approach is to recognize that benefit changes and plan experience will not always be accurately predicted by the actuary on a year-to-year basis, and therefore, the costs associated with these items are isolated, measured and amortized separately over a fixed period of years. The fundamental concept is that these separated costs, this accrued liability, represents accumulations of past miscalculations and the retroactive effects of all benefit changes.

A new *unfunded accrued liability* is established each year by subtracting the current assets of the fund from the accrued liability. Prior law treated this unfunded accrued liability as a "mortgage" required to be amortized in **equal annual payments over a 40-year period which began on January 1, 1980.** Payments on this unfunded accrued liability are the cornerstone of the funding equation. Left unattended this unfunded accrued liability, as a mortgage, would continue to increase simply by the operation of interest.

The State Actuary each year measures the relationship of the current assets of the plan to the amount of the accrued liability and determines the "percentage funded". This index is well publicized and used as a guideline in determining the benefit security of any particular fund. Many funds take pride in the fact that they are 100% funded and often criticize funds which are in poorer financial condition. The average Downstate Police and Fire Plan is about 75%-80% funded.

LEGISLATED CHANGES IN FUNDING THE PENSION PROGRAM

Recent legislation has lengthened the period over which the unfunded accrued liability is to be amortized, ***but more importantly***, has also changed the method of computation of the annual payment. Continuing with our example of a mortgage, these changes can be viewed as a general refinancing.

Under new law the unfunded liability is required to be amortized over a **new 40-year period which begins July 1, 1993 as a** level percentage of payroll rather than in equal annual payments. In mortgage terms, we have refinanced the liabilities over a new 40-year period and we have set up payments under a ***negative amortization schedule***. Under negative amortization, payments are initially determined at an artificially low amount which are scheduled to increase dramatically in future years but which currently are insufficient to fund the interest portion of the mortgage.

Let's look at some numbers.

Assume that a police fund has an ongoing **normal cost** of 27% of payroll or $300,000 for 1993. Further assume that member contributions total $100,000 in 1993 (9% of payroll) and that the fund has total accrued liabilities of $5,000,000 and total assets of $4,000,000 (or an **unfunded liability** of $1,000,000). In this example, the total calculated payment on July 1, 1993 under prior law is $378,486 ($300,000 for the normal cost plus $78,486 to amortize the unfunded liability). Since the members are contributing $100,000 towards this payment, the municipal contribution is $278,486 or 25.06% of payroll. Note that the fund is 80% funded ($4,000,000/$5,000,000) on July 1, 1993.

If there are no benefit changes and the funds earn exactly 7% (the State Actuary's assumption) and if salaries rise exactly 5½% (the State Actuary's assumption) then, under prior law, the unfunded liability would begin to **decrease** annually until it completely disappears in the year 2020. Since the amortization period has been extended to 2033 under new law, the unfunded liabilities would not be fully amortized until 2033 but they would still **decrease** annually. However, because the new law permits the amortization as a level percentage of payroll, rather than as a level dollar payment, the unfunded liabilities would initially **increase**. The following table is informative.

GROWTH IN UNFUNDED LIABILITIES

Year	Prior Law Level $ Funding	New Law Level $ Funding	New Law Level % Funding
1993	$ 1,000,000	$ 1,000,000	$ 1,000,000
2001	856,569	948,607	1,292,905
2009	610,127	860,305	1,568,777
2017	186,693	708,585	1,693,101
2025	-0-	526,833	1,520,858
2032	-0-	70,102	262,177

TABLE 1

As Table 1 clearly shows, the unfunded liabilities will grow to almost 70% higher under the new method of funding than under the former method, **even after the extension of the amortization period.** The following graph is more illustrative than the table.

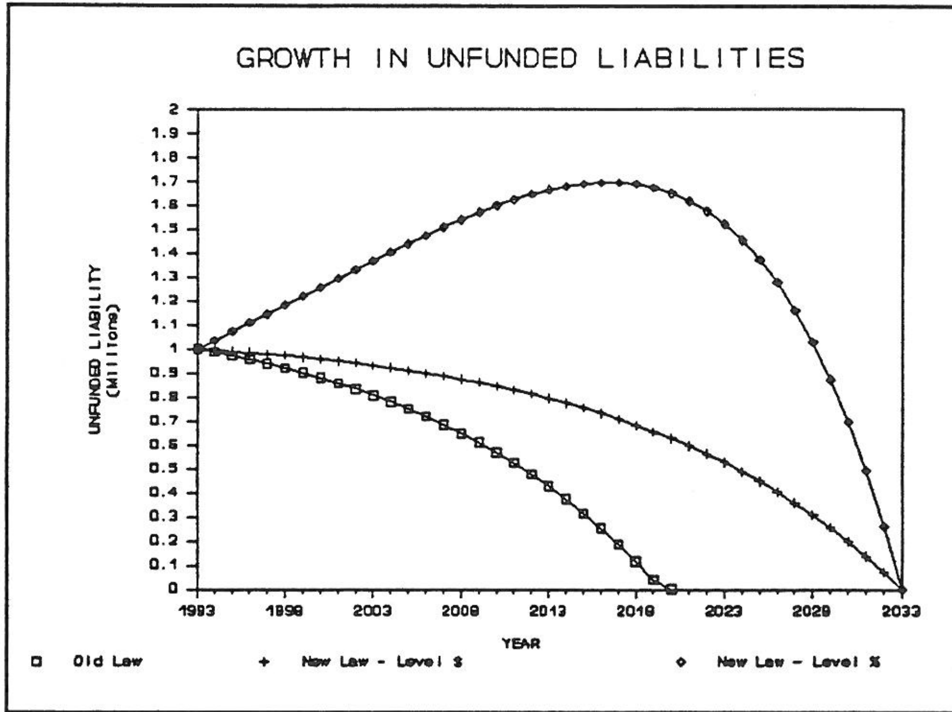


Figure 1

It is important to note that although the new funding method will, in fact, fully amortize the unfunded liabilities by the year 2033, the actual unfunded liabilities will dramatically increase before they begin to decrease, **even if all actuarial assumptions are exactly realized.**

IMPACT ON MUNICIPAL CONTRIBUTIONS

What happens to the municipal contribution level under the new law?

Since the new law provides that unfunded liabilities will be amortized as a level percentage of pay rather than as a level dollar amount, the annual municipal contribution is expected to remain level as a percentage of pay. In theory, this is a desired result for budgeting purposes. However, in operation, the actual ability to afford the magnitude of the absolute dollar cost increases is questionable.

Examining the municipal payment in two pieces is appropriate. The payment on the normal cost, by definition, is always a level percentage of payroll. This normal cost is offset by the 9% contributions made by the police officers. In our example, this ***net*** municipal cost is a constant 18% of payroll--an initially affordable amount. The payment on the unfunded liability under new law also is a constant percentage of payroll--in our example, slightly under 3% of payroll. But as payroll increases, this amortization payment also increases. Figure 2 illustrates this concept.

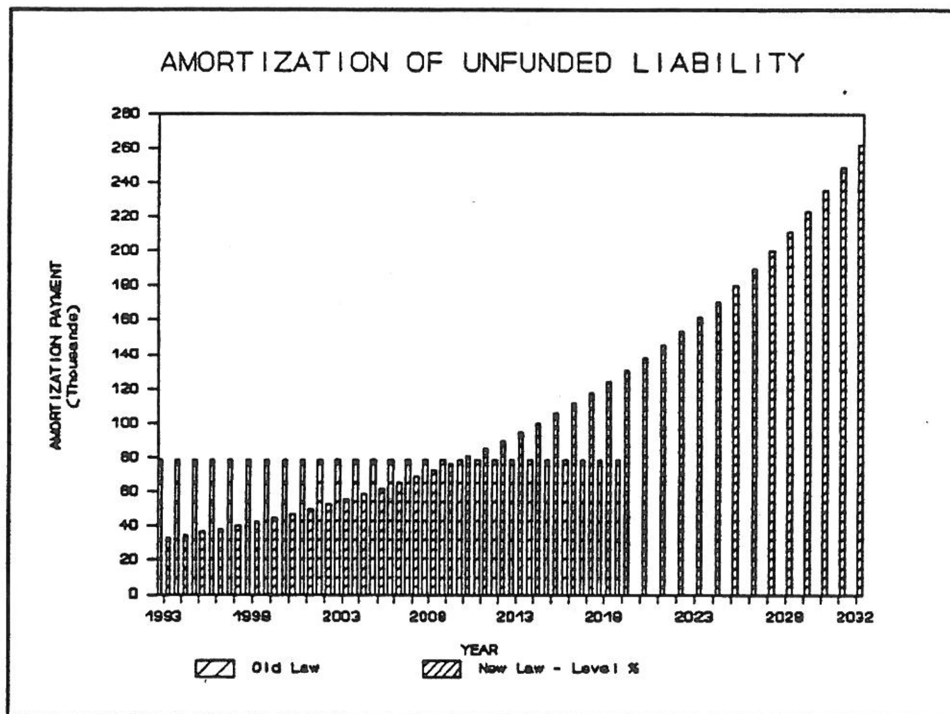


Figure 2

Note that the amortization payment in the early years is approximately 60% lower under the new law than under prior law. By the year 2020, when the unfunded liability was originally scheduled to be fully amortized, the amortization payment will be over 66% higher than under prior old law. By the end of the 40-year period, in 2033, the amortization payment will be almost 3½ times the original prior law payment.

By virtue of this deferring of actual amortization, the municipal contributions in dollars are correspondingly lower to start, but then dramatically increase. Figure 3 compares the total municipal contribution under both the old law and the new law.

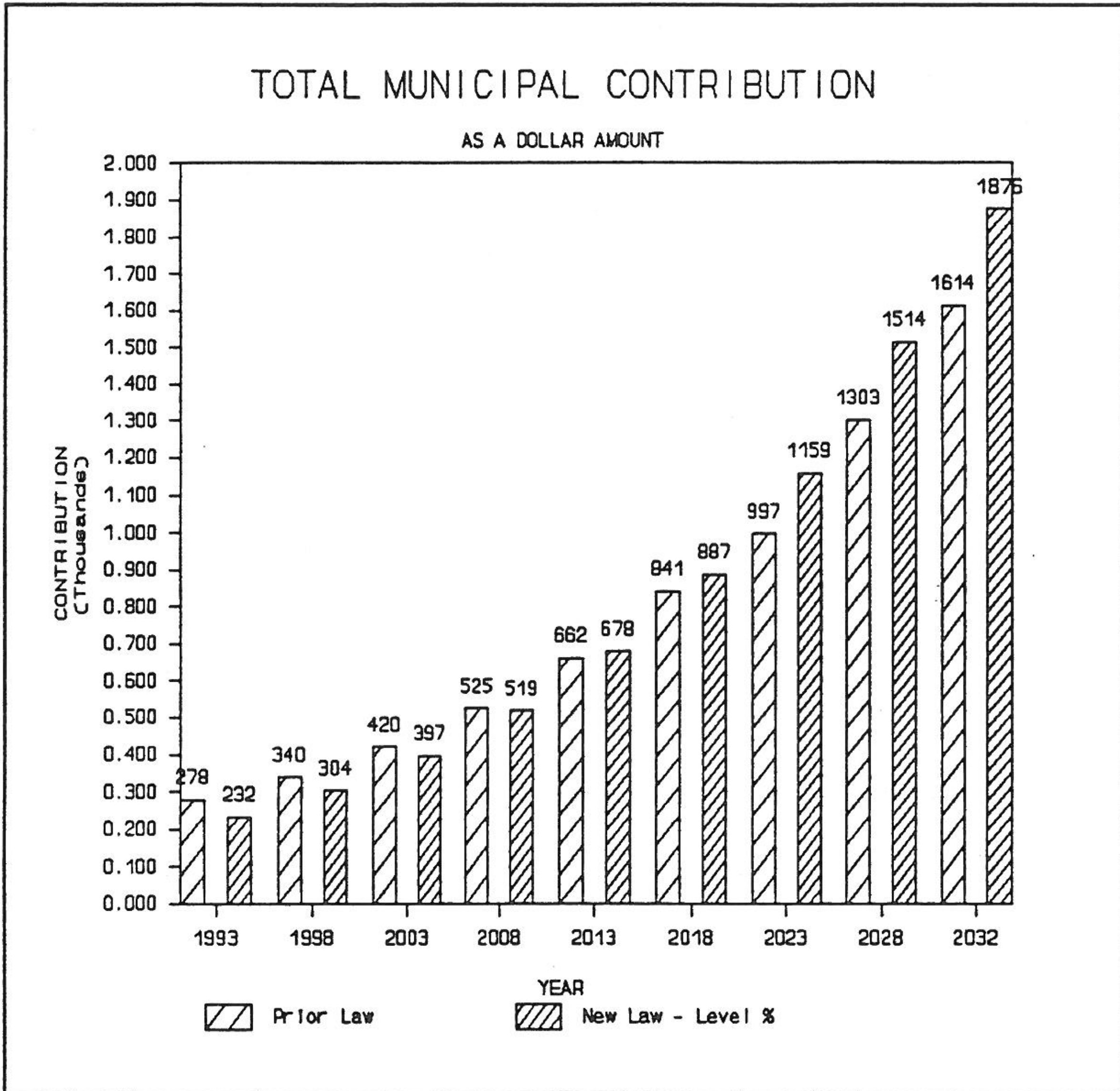


Figure 3

Figure 4 below illustrates the actual municipal contribution dollar differential under the new law and the prior law.

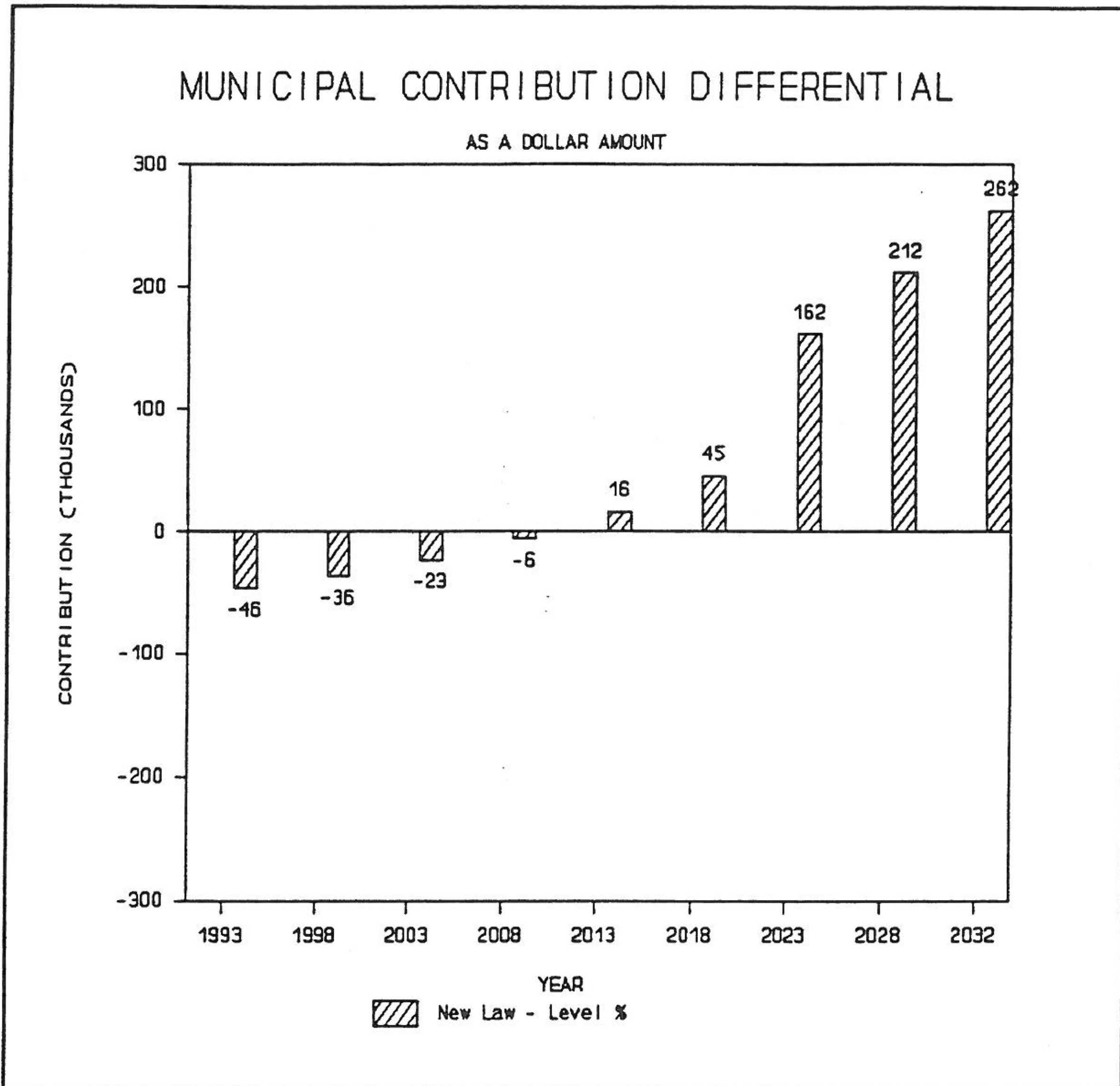


Figure 4

As shown above, municipal contributions remain below the originally scheduled amount for the next 10 years. **Future generations of taxpayers will be paying for pensions being earned today!!**

EFFECT ON POORER FUNDED PLANS

Our previous discussion has addressed the plan which was 80% funded. What about the plan which is only 60% funded? or 40% funded?

As expected, the concepts remain the same; that is, the unfunded liabilities will continue to grow, the amortization payments initially are lower, and the municipal contribution is correspondingly lower. However, all the magnitudes change. The following table compares the actual municipal cost differentials for various funded plans.

DIFFERENTIAL IN MUNICIPAL CONTRIBUTION
NEW LAW COMPARED TO PRIOR LAW

Year	80% Funded	60% Funded	40% Funded	20% Funded
1993	(46,000)	(92,000)	(138,000)	(184,000)
2020	52,000	104,000	156,000	208,000
2033	262,000	524,000	786,000	1,049,000

TABLE 2

EFFECT OF ACTUARIAL EXPERIENCE

It must be remembered that all of the foregoing examples are based upon the fund experience in accordance with the State Actuary's assumptions. When actual experience differs from the assumed, the differences are absorbed into the unfunded liability. It follows, therefore, that since the payments on the unfunded liabilities are being passed into the future, the plan's current experience is also being passed into the future. In a nutshell, today's lower interest rates will cause the future fund payments to grow even larger.

Unfunded liabilities which initially grew to 70% higher because of the new negative amortization schedule now will more than double for plans which are initially 60% funded.

To illustrate the cost impact, examine the following table which shows the effect on the municipal contribution level, if the fund actually earns 6% for the next five years and then returns to the 7% level.

DIFFERENTIAL IN MUNICIPAL CONTRIBUTION
NEW LAW COMPARED TO PRIOR LAW
EFFECT OF ACTUARIAL EXPERIENCE

Year	80% Funded	60% Funded	40% Funded	20% Funded
1993	(46,000)	(92,000)	(138,000)	(184,000)
2020	61,000	111,000	161,000	211,000
2033	338,000	593,000	850,000	1,107,000

TABLE 3

Comparisons between the municipal contribution differential shown in Table 2 and the municipal contribution differential in Table 3 clearly show that minor investment losses experienced today go virtually unrecognized until 25 to 30 years in the future. Furthermore, a prolonged period of depressed investment results could effectively bankrupt a fund 20 or 30 years from now.

OTHER CONSIDERATIONS

The model we are using is necessarily simple so that basic concepts can be presented. Our example assumes that no participants retire, become disabled or die. In the real world, pension funds will experience retirements, disabilities and deaths and each of these events affect the unfunded liability of a particular fund. Pension Funds which have large numbers of pensioners, adverse experience with regard to disabilities, varying investment returns, or scheduled salary increases which are greater than those assumed by the actuary, will find that their unfunded liabilities will grow to numbers far greater than those illustrated. However, municipal contributions for the next 10 years or longer will barely change and still be far below what the old law funding schedule required.

WHAT CAN BE DONE?

Understanding and education of Pension Trustees is the best solution to this problem. This article is a first step toward education of Pension Trustees.

In practical terms, boards have the authority under law to recommend contributions to the Municipalities. The State Actuary appears bound by new law to calculate contributions under the revised funding schedule. Boards should recognize that the new schedule does not protect the pensions being earned by participants and, therefore, should reject the State calculated figures. Independent actuarial advice can be provided for those funds which choose to hire an outside consultant. An independent actuary can provide a recommended funding level which will protect the plan participants.

It's your pension--and it may not be there when you expect it!!

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

JAMES MCNAMEE, et al., Plaintiffs, v. THE STATE OF ILLINOIS; JIM EDGAR, Governor, STEPHEN F. SELCKE, Director, ILLINOIS DEPARTMENT OF INSURANCE, Defendants.	NO. 94 CH 884 Honorable Judge Green

ORDER

This case is before the Court on the plaintiffs' motion for summary judgment, the Court having heard arguments of counsel and having read the memoranda submitted:

IT IS HEREBY ORDERED:

(A) That for reasons stated in open court the plaintiffs' motion for summary judgment is granted and the plaintiffs are entitled to judgment as a matter of law;

(B) The Court issue a declaratory judgment finding that Section 3-127 of the Illinois Pension Code, 40 ILCS 5/3-127 as amended by Public Act 87-126 is unconstitutional as being in violation of Article XIII, §5 of the Illinois Constitution in that the amendment to Section 3-127 diminishes and impairs the contractual rights of participants and beneficiaries who are members of Article 3 police pension funds; and

(C) Judgement is entered in favor of the plaintiffs and against the defendants.

Atty No. 89500
Name SKLODOWSKI, FRANKLIN, PUCHALSKI & REIMER
Attorney for Plaintiffs
Address 111 W. Washington, #1000
City Chicago, IL 60602
Telephone (312) 332-4428

______________________, 19____

ENTER:

Judge Judge's No.

AURELIA PUCINSKI, CLERK OF THE CIRCUIT COURT OF COOK COUNTY

C 237

PROOF OF SERVICE

RICHARD J. PUCHALSKI, hereby states that he mailed twenty (20) true and correct copies of the foregoing Brief and Appendix of the Plaintiffs-Appellees to the Clerk of the Supreme Court of Illinois and three (3) true and correct copies of said Brief to each person indicated below at the respective address shown by depositing the same in the U.S. mail in Chicago, Illinois this 2nd day of April, 1996.

Juleann Hornyak
Clerk of the Supreme Court
Supreme Court Building
Springfield, Illinois 62706

Jerald S. Post
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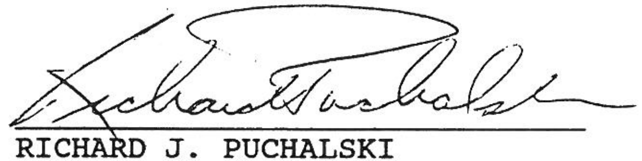

RICHARD J. PUCHALSKI