Pension Pointers

Solving the Funding Conundrum: The Essential Challenge of Pension Consolidation

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From the moment the Illinois Pension Consolidation Feasibility Task Force issued its report to Governor Pritzker in October 2019[1], the focus of firefighter and police pension fund consolidation has squarely been on investments. Sold on the notion that the roughly 650 individual funds "face[d] headwinds" because of their relatively small size and resulting lack of access to investment opportunities, the Illinois General Assembly consolidated these funds into two statewide systems, now operational as the Firefighters' Pension Investment Fund (FPIF) and the Illinois Police Officers' Pension Investment Fund (IPOPIF).

In the year since the January 1, 2020, effective date of P.A. 101-0610, the transition boards of trustees of both consolidated funds have been working to hire staff and establish their operations, focusing primarily on election procedures to seat the permanent nine-member boards by January 2021. For the next 18 months, both consolidated boards will now be focused on the transfer of assets from their respective individual firefighter or police pension funds to establish the consolidated asset pool that these consolidated funds will invest and manage going forward.

The task ahead to properly audit then coordinate the transfer of hundreds of portfolios is a significant undertaking that will require the services of outside professional accountants, auditors, and investment consultants, as well as well-trained internal staff. The consolidation law contemplates that this all must be completed by the end of the "transition period," which is June 30, 2022.

Putting aside, however, the focus of the consolidation on investments, the more pressing concern facing Illinois pension funds is the issue of funding. The Task Force recognized the seriousness of the funding issue but left unresolved the challenge of proper funding as one to be reviewed in "step 2" of the Task Force's work. Specifically, the Task Force noted concerns regarding the "funding ramp" currently set forth in Sections 3-125 and 4-118 of the Illinois Pension Code, which as of 2011, modified the actuarial approach to the financing of police and firefighter pension funds by the underlying municipality or fire protection district to a "statutory minimum approach."

Under the Illinois Pension Code, the required minimum employer contribution for downstate police and firefighter pension funds is calculated using the projected unit credit (PUC) actuarial method as a "level percentage of payroll" sufficient to bring the assets of the fund to 90% of the fund's total actuarial liabilities by the year 2040. Explaining its concerns, the Task Force stated:

The arguments in favor of considering a review of the ramp include the following: While consolidation of assets will be a strong net positive to the pension plans and therefore their beneficiaries, *additional time may be needed on the required employer contribution schedule* for the pension plans to benefit from improved year-over-year investment returns. [emphasis added]

While hedging on the initial expected favorable impact consolidated asset returns may bring to the pension funds, the Task Force clearly advocated for additional time beyond the year 2040 for employers to make their required contributions under the current statutory scheme. This is understandable, given the poor statutory choice of projected unit credit (PUC) as the actuarial method to prepare the contribution calculation. Projected unit credit (PUC) is not well suited for use in the public pension fund setting, because of its low contribution requirement at the beginning of a public employee's career, with a steep increase in that contribution requirement at the end of the employee's career.

The Securities and Exchange Commission famously condemned the State of Illinois' use of PUC and the 90-percent funding target in its order issued in March of 2013, in which the state was directed to cease its misleading information about the adequacy of its statutory plan to fund its pension obligations to the statewide systems in its bond documents. Calling it "structural underfunding," the SEC wrote:

The State's use of the projected unit credit ("PUC") actuarial cost method compounded the risk of the Statutory Funding Plan. The PUC method, used by Illinois and a minority of states, allocates a higher portion of retirement costs closer to retirement, while the entry age normal ("EAN") method, used by a substantial majority of public sector plans, averages those same costs evenly over the pensioner's period of employment. *Compared to an EAN approach, the PUC method results in less funding for active employees, accumulates assets more*

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slowly, produces more volatile measures of contributions rates, and results in rising rather than level contribution rates. [emphasis added][2]

While this methodology may have provided temporary relief to municipalities and fire protection districts in the years initially following 2011, now ten years later, the required statutory minimum funding is beginning to rise sharply for many employers. Coupled with the reality of tax caps and related pressures to minimize additional property tax increases, plus a low interest rate environment and volatile markets, the pressure on municipalities and fire protection districts to meet statutory minimum funding requirements in many instances is immense.[3]

Importantly, the Task Force recommended not only a review of the feasibility of the 2040 funding date, but it also specifically stated in its report that the funding date must be reviewed "in conjunction with other actuarial changes *to help front-load contributions* and thereby curb the annual rate of growth in employer contributions." What does this mean? What should it mean?

What it *does* mean and what it *should* mean is the difference between what will become an inevitable clash between politics and professional actuarial opinion. In other words, what may be politically efficient in the near term for the affected municipalities and fire protection districts who are struggling to properly fund their police and firefighter pension funds is clearly diametrically opposed to the sound actuarial goal of front-loading contributions. Can these goals be reconciled?

Historically, our state has chosen poorly on setting statutory frameworks for funding not only for the downstate firefighter and police pension funds, but also the statewide and Cook County pension systems. The political appetite in Illinois has favored deferred pension contributions for decades; the consequences of this diet are forgone investment earnings which now must be made up in the form of escalating employer contributions. When the choice is made to disregard professional actuarial advice to *front-load contributions*, the outcome is more costly pension systems for taxpayers.

Illinois' constitutional protection of promised pension benefits—the Pension Protection Clause--is considered one of the strongest legal protections of such benefits in the nation (ILL. CONST. 1970, art. XIII, §5). Despite legislative efforts to diminish previously promised pension benefits to Illinois public employees, the Pension Protection Clause has withstood a myriad of challenges and continues to foreclose efforts to reform the Illinois Pension Code that would modify benefit structures to offload risk from employers onto participants, as has occurred in many other states.[4] While the impetus to adopt the Pension Protection Clause may have been to provoke improved funding of Illinois pension funds, the protection the clause provides to the *benefit* and not

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necessarily to the *funding* of the benefit did not produce its intended effect.

Meanwhile the climate is becoming more dangerous for public pensions. In Illinois, the recent rejection of efforts to modify the state's constitution to allow for graduated income taxation which could have provided an influx of resources for pension funding underscores the taxpayers' disinterest in contributing more revenue to the state.[5] The COVID-19 pandemic has strained state and local government resources. Coupled with a political environment that increasingly favors outcome over process or law, could the legislature and the courts find themselves under more pressure to find a path to support modification of promised pension benefits?[6]

Furthermore, municipalities continue to seek pension funding relief through a bill on funding that has been pending since January 30, 2019. HB 1572 would modify Sections 3-125 and 4-118 to further diminish the statutory minimum funding of police and firefighter pension funds, by changing the funding goal to 80% (currently, 90%) and the funding date to year 2050 (currently, 2040). HB 1572 would certainly satisfy the goal of political expediency; it would also most certainly deliver a death blow to those firefighter and police pension funds that are substantially underfunded and struggling with significant cash flow concerns in making benefit payments.

Unless every fiduciary involved recognizes their legal obligation to speak up on these issues, finding a path to establishing and maintaining an effective funding policy will continue to be a piecemealed approach, with some municipalities and fire protection districts finding the means and commitment to proper funding and others taking the precarious statutory minimum path to potential insolvency.

Significantly, Section 1A-111 of the Illinois Pension Code was modified by P.A. 101-0610 to provide that at the conclusion of the transition period (June 30, 2022), the actuarial statements for every Article 3 and 4 pension fund will be prepared by a qualified actuary retained by the consolidated funds. Under the revised statute, any changes in assumptions used by the consolidated fund's actuary that increases or decreases the actuarially required contribution for the funds are to be implemented in equal annual amounts over a three-year period, beginning in the fiscal year of the fund in which such change first occurs.

As a result, this fiduciary obligation to proper funding includes the necessary involvement and leadership from the trustees and professional staff of the two consolidated boards. If the mindset of the consolidated boards is not focused on *front-loading of contributions*, their responsibility for producing the actuarial statements for their member pension funds after the conclusion of the transition period becomes problematic. By giving over the actuarial responsibility to the consolidated funds, this second step in consolidation will either provide an opportunity for improving funding or may cement further poor practices currently in place with those municipalities and fire protection districts that have relied on statutory minimum funding.

Some of this may be hashed out through the Task Force efforts; however, trustees serving on their local police and firefighter pension funds need to be engaged and vocal in this process as fiduciaries. It is also incumbent on the actuarial community that services public pension funds to speak up publicly on the issues of appropriate actuarial methodology and assumption choices; no longer can actuaries allow themselves to be pressured to provide less than actuarial valuations that reflect best practices. But in the end, if the fiduciaries to the pension funds fail to demand proper funding, then it is assured that no one will. ■

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1. *Report to Governor JB Pritzker – Illinois Pension Consolidation Feasibility Task Force, October 10, 2019.*
2. *In the Matter of State of Illinois, SEC Administrative Proceeding File No. 3-15237 (March 11, 2013).*
3. *In addition, Tier 2 benefit improvements which were an important part of P.A. 101-0610's consolidation package have also created new, and in some cases significant, unfunded liability for those pension funds with a large number of Tier 2 members. This has resulted in higher required employer contributions for many municipalities and fire protection districts this year.*
4. *See, for example, In re Pension Reform Litigation, 2015 IL 118585, in which the Illinois Supreme Court struck down the constitutionality of a law amending the Illinois Pension Code which would have significantly low benefits for members first contributing to the various state pension systems prior to the effective date of the law.*
5. *"Editorial: Voters finally tell Springfield 'No,'" Chicago Tribune (November 3, 2020).*
6. *For example, a recent decision by the California Supreme Court chipped away at the "California Rule" which has historically provided strong protection of public pensions in Alameda County Deputy Sheriff's Association v. Alameda County Employees' Retirement Association, 9 Cal.5th 1032 (July 30, 2020). In this case, the court upheld a law that ended the practice of pension spiking for county employees that was enacted, according to the court, for the "constitutionally permissible purpose of closing loopholes and preventing abuse of the pension system."*