

**Report to Governor JB Pritzker
Illinois Pension Consolidation Feasibility Task Force**

October 10, 2019

Table of Contents

1. Executive Summary
2. Background on Illinois Pension Plans
 - a. Suburban & Downstate Police & Fire Pension Plans
 - b. Cook County & City of Chicago Pension Plans
 - c. Illinois Statewide Pension Systems and Other Pension Plans
3. Recommendation, Step 1: Consolidate Suburban & Downstate Police & Fire Pension Plan Assets
4. Recommendation, Step 2: Review Consolidation of Suburban/Downstate Police & Fire Pension Plan Benefit Administration; Review of Other State and Local Plans to Determine Advantages of Consolidation
5. Conclusion
6. Appendix: Illinois Pension Consolidation Feasibility Task Force Creation & Members

Executive Summary

Of the financial challenges facing the State of Illinois, perhaps the most critical to state and local governments' overall long-term financial health is the long-standing challenge of our unfunded pension liabilities and the ever-increasing burdens that places on local property taxes. Illinois has more than 660 funds, the second-highest number of pension plans of any state in the country.

Within the constellation of pensions in Illinois, roughly 650 of them are suburban and downstate police and fire plans, most of which face headwinds in large part caused by the relatively small size of each plan. Because many are so small, they are unable to gain access to investment opportunities that provide the highest returns and competitive investment fees. Collectively these pension plans today earn significantly lower investment returns than larger pension plans. For example, suburban and downstate police and fire plans generated on average 2 percentage points less annually over the past 10 years than the statewide municipal employees' fund. In addition, these numerous small funds pay substantially higher expenses to manage their assets and administer benefits. The sheer number of plans and the extraordinarily modest asset levels relative to other plans exacerbate both of these challenges.

Not only does this negatively impact the funding level of police and fire pension plans, but local taxpayers are left with the burden of paying taxes to make up for these lower investment returns, forcing most municipalities to rely on a never-ending cycle of increasing local property taxes or cutting services to meet their pension obligations.

To help solve the police and fire pension funding problem and relieve the burden on taxpayers, Governor Pritzker announced the creation of the Pension Consolidation Feasibility Task Force on February 11, 2019, to explore and make recommendations for consolidation of pension funds in order to achieve the greatest value for employees, retirees, and taxpayers. Members of the task force include municipalities, labor unions, former elected officials and financial experts.

After eight months of data collection, analysis, and many meetings, the Task Force recommends the State take the following actions:

STEP 1: Consolidate suburban & downstate police & fire pension plan assets.

The single most impactful step that the State can take to address the underfunding of downstate and suburban police and fire pension funds is to consolidate the plans' investment assets. This step is immediately actionable and beneficial to the health of the plans, retirees, and taxpayers. Analysis by the Department of Insurance estimates that if the **more than \$14 billion** of suburban and downstate police and fire plans were to achieve investment returns similar to the other larger Illinois plans over the next five years, they would collectively generate an additional **\$820 million to \$2.5 billion** in investment returns alone. If they were to achieve comparable returns over the remaining 20 years on their statutory ramp to 90% funded status, they would create an additional **\$3.6 to \$12.7 billion** in investment returns alone.

To achieve this consolidation, the Task Force recommends that the State create two new funds, one for municipal police beneficiaries and one for municipal fire beneficiaries, to pool the assets of the roughly 650 downstate and suburban police and fire funds and manage those assets. Each fund would be

governed by a board with equal representation of employees and employers. Each local pension plan would maintain an individual and separate account within the new consolidated funds, such that no assets or liabilities are shifted from one plan to another. Each of the two consolidated funds will be held in independent trusts, separate from the State Treasury, with sole governance provided by their respective boards.

With up to \$1 million a day in lost investment returns to the pension plans, the Task Force recommends there be legislation passed by the General Assembly in the fall of 2019 that will achieve this consolidation.

In addition, the Task Force recommends other statutory changes to ensure the State is compliant with the safe harbor standard of the Social Security Administration and Internal Revenue Code, thereby avoiding substantial and sudden future costs to municipalities resulting from non-compliance.

STEP 2: Review consolidation of suburban/downstate police & fire pension plan benefit administration; review of other state and local plans to determine advantages of consolidation

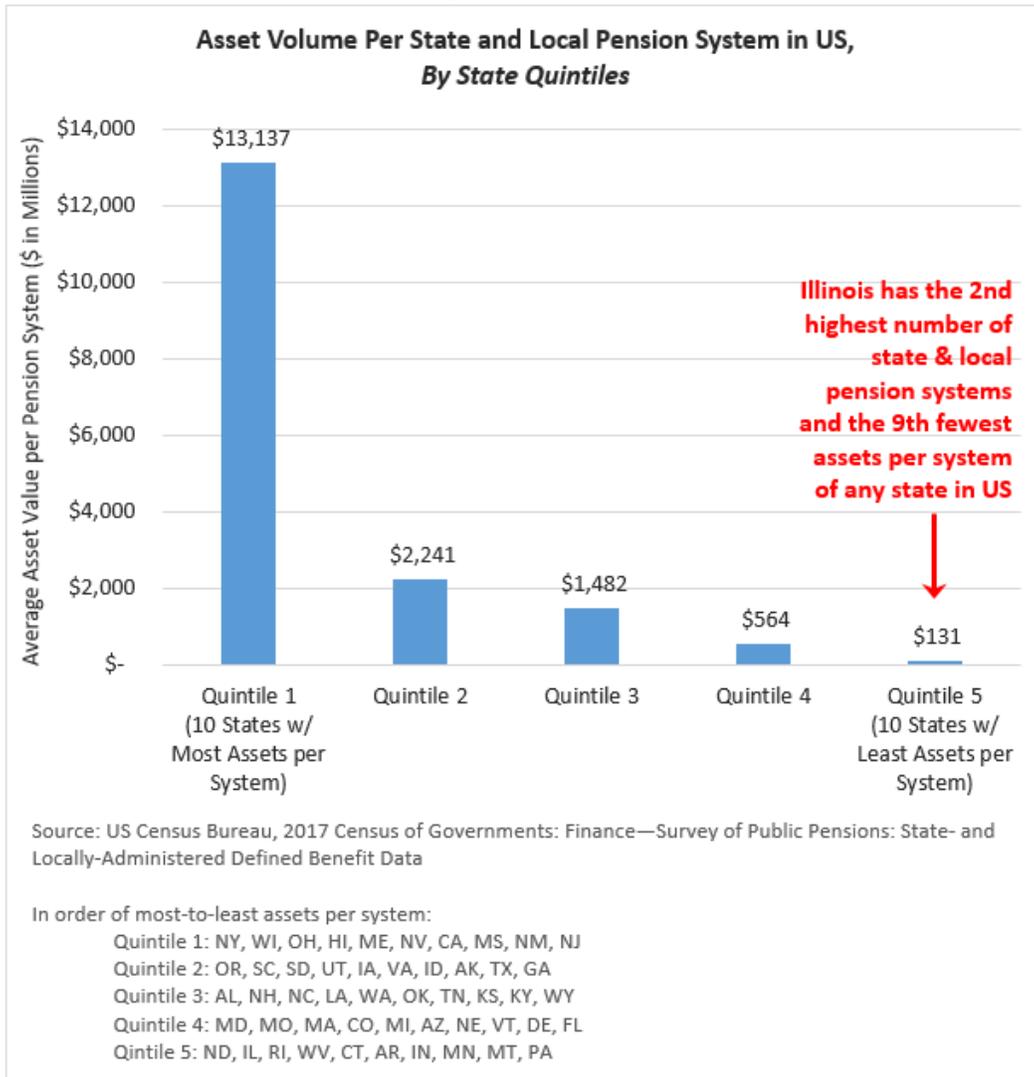
Downstate and suburban police and fire funds face further financial challenges beyond just the underperformance of investment returns and high cost of administering assets of these systems that consolidation will address. Therefore, the Task Force recognizes there may be additional advantages to consolidating the benefit administration of these plans. However, because such action requires further discussion with those who would be affected by such a change, it is the recommendation of the Task Force that it should continue to review the advantages and challenges of consolidating benefit administration, and to make potential recommendations to the Governor on this issue.

Additionally, there are 15 other pension systems in Illinois outside of suburban and downstate police and fire that bear significant financial burdens. Unlike suburban and downstate police and fire plans these funds are larger funds, and consolidation would not achieve material improvement of their investment returns. Because the current financial pressures on these systems are so significant, especially for the City of Chicago, it is recommended that the Task Force to continue to review the potential advantages of consolidation of these larger systems and to make recommendations to the Governor on this issue.

Background on Illinois Pension Plans

In the United States, all state governments maintain some form of retirement system(s) (or otherwise referred to as “funds” or “plans”) for the retirement security of their public employees. The size, shape, form, and number of these systems varies dramatically, however, across states. Pennsylvania, Illinois, and Minnesota are the states with the highest number of public state and local pension systems, with 1,597; 664; and 577, respectively. 78% of states in the US have fewer than 100 state and local pension systems, with 26% of states having fewer than 10. As for the size of each state’s average state and local pension system, Illinois ranks 42nd out of 50 states for the average value of total assets per pension system.¹

Chart 1: Size Comparison of Pension Plans in US



¹ US Census Bureau, 2017 Census of Governments: Finance—Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data, with amended Illinois local funds based on Department of Insurance FY 2017 report

In other large states with comparable population size (such as New York, California, and Texas), the number of pension systems are significantly less than Illinois (9, 86, and 140, respectively). For a regional comparison, Ohio has only one pension system for all police and fire personnel, and 8 state and local pension systems in total. Some states that have gone through a consolidation process over the years include Wisconsin, Massachusetts, West Virginia, Ohio, and Colorado. Two specific state systems that have substantially consolidated assets are the Massachusetts Pension Reserve Investment Management Board (PRIM) and the State of Wisconsin Investment Board (SWIB). PRIM, for example, is a not-for-profit agency with a chief investment officer and other investment managers specializing in various markets such as real estate, private equity, hedge funds, etc. Salaries and other costs of operation are charged on a pro rata basis back to the participating funds. ²

Suburban and Downstate Police and Fire

In Illinois, the vast majority (649) of the existing 664 pension plans are for police and fire personnel employed by municipalities outside of the City of Chicago.³ These plans are commonly referred to as “suburban and downstate” police and fire pension plans. While 98% of Illinois pension plans are for suburban and downstate police and fire, their plan assets represent less than 10% of the total plan assets for all Illinois public pension plans. This makes these plans unique to the other plans in the state in that their governmental aggregate volume of assets is significantly smaller than the other Illinois, Cook County, and City of Chicago plans.

Table 1: Average Volume of Assets by IL Pension Plan Category (\$ in Millions)

<u>Plan Category</u>	<u># of Plans</u>	<u>Average Actuarial Value of FY 2017 Assets Per Fund</u>
Suburban & Downstate Police & Fire Plans	649	\$22
Cook County & City of Chicago Plans	9	\$3,533
Illinois Statewide Plans	6	\$16,883

While the average suburban and downstate police and fire pension plan has \$22 million in actuarial value of assets, 65% of those plans have less than \$20 million in assets, and 44% of them have less than \$10 million in assets.⁴

² Sources: Boston Consulting Group analysis; March 2019 phone conversation with Keith Brainard, Research Director of National Association of State Retirement Administrators (NASRA); March 2019 phone conversation with Michael Travaglini, prior senior staffer at PRIM.

³ The number of plans varies year-to-year and as such, these numbers may differ slightly from other publicly-available sources

⁴ Source: Illinois Department of Insurance, Public Pension Division, 2017 Biennial Report

Table 2: Suburban and Downstate Police and Fire Pension Plan Asset Volumes (\$ in Millions)⁵

<u>Plan Assets</u>	<u>Count</u>	<u>% of Total Count</u>	<u>Total Actuarial Value of FY 2017 Assets</u>	<u>% of Total Assets</u>
\$0-\$10M	285	43.9%	\$1,136	7.9%
\$10M-\$20M	139	21.4%	\$2,069	14.4%
\$20M-\$30M	88	13.6%	\$2,182	15.2%
\$30M-\$40M	47	7.2%	\$1,627	11.4%
\$40M-\$50M	26	4.0%	\$1,118	7.8%
\$50M-\$60M	9	1.4%	\$539	3.8%
\$60M-\$70M	10	1.5%	\$653	4.6%
\$70M-\$80M	15	2.3%	\$1,132	7.9%
\$80M-\$90M	8	1.2%	\$677	4.7%
\$90M-\$100M	1	0.2%	\$96	0.7%
\$100M+	21	3.2%	\$3,092	21.6%
Total	649		\$14,321	

As of December 31, 2017, the smallest and the largest suburban and downstate plan assets among these pension funds held \$2,000 and \$250 million, respectively, with only 3% of the plans having assets exceeding \$100 million. Due to liquidity concerns around smaller plans bearing larger risk, plans with smaller size generally achieve substantially lower investment returns. In addition to a wide gap in assets, the number of active fund participants varies greatly by fund. The average number of plan participants per plan is only 67 individuals, with 24 plans having only one active participant. Only five suburban and downstate police and fire plans have more than 500 active participants, with the Rockford Police Pension Fund having the most at over 600.

⁵ Based on Illinois Department Insurance data available in the spring of 2019

Table 3: Funded Levels of Suburban and Downstate Police and Fire Pension Plans

IL Department of Insurance Pension Division Summary of Pension Funds in Article 3 and Article 4 of IL Pension Code Data as filed for Fund's FY 2017 (\$ in Millions)						
<u>% Funded Range</u>	<u># of Funds</u>	<u>Total Participants in Funds</u>	<u>Actuarial Value of Assets (A)</u>	<u>Actuarial Calculated Accrued Liabilities (L)</u>	<u>Unfunded Accrued Liability (L-A)</u>	<u>Avg. % Funded (A/L)</u>
201% - 700%	3	8	\$5.2	\$1.3	-\$3.9	397%
151% - 200%	2	23	\$7.4	\$4.4	-\$2.9	166%
101% - 150%	17	385	\$208.7	\$199.0	-\$9.8	105%
81% - 100%	36	1,107	\$411.7	\$479.0	\$67.3	86%
61% - 80%	207	12,534	\$5,142.6	\$7,477.9	\$2,335.2	69%
41% - 60%	275	23,976	\$7,601.6	\$14,585.2	\$6,983.6	52%
21% - 40%	21	671	\$893.9	\$2,765.6	\$1,871.7	32%
0% - 20%	88	4,963	\$53.9	\$340.5	\$286.6	16%
Total	649	43,667	\$14,325.0	\$25,852.9	\$11,527.9	55%

Notes:
 (1) Four funds did not submit an Annual Statement in FY 2017. Pending hearings.
 (2) The funds with over 151% are new funds with more active participants than annuitants or have only one member in the fund.
 (3) The information is based on the Division's enrolled actuary valuation reports with assumptions developed and documented in 2017 experience report.
 (4) Assets are calculated based on a five year smoothing as required by Article 1 of the IL Pension Code.

The funded ratio for the average suburban and downstate police and fire pension plan is 55% funded, with 59% (384 of 649) of funds at or below a 60% funded level. In many of these plans, the cash inflows (contributions from employers and employees, and investment returns) are less than the cash outflows (benefits and expenses). Also, their investment returns are often less than their assumed actuarial discount rate, meaning the average unfunded accrued liability gap of 45% is unlikely to ever be closed without major corrective action.

For the purposes of this Task Force, the Illinois Department of Insurance conducted an analysis of the investment returns of these plans, looking at 592 suburban and downstate police and fire plans from FY 2004 to 2013.⁶ The market values of the sample plan assets were \$6.7 billion in FY 2004 and \$11.5 billion as of FY 2013, and earned an annual average of 5.61% on investments, net of fees. The Department then looked at what those plans would have earned had they been pooled together into a larger system to take advantage of economies of scale, broader investment options, and more choices on investment vehicles. The analysis showed that had they performed similarly over the FY 2004-2013 time period to the Illinois State Board of Investment (ISBI) or the Illinois Municipal Retirement Fund (IMRF), they would have returned 6.73% or 7.62%, respectively. These two systems were used as a basis for comparison because of their composition of a pooling of smaller funds. This 112 to 201 basis-point increase in returns would have netted suburban and downstate police and fire plans an additional estimated **\$160 million to \$288 million** annually.

⁶ Some funds were excluded from the analysis because they either had different fiscal year dates, or were terminated at some point during the 10-year period of analysis.

Table 4: Comparison of Suburban & Downstate Police & Fire Plans' Net Investment Returns to IMRF & ISBI, FY 2004 - 2013

FY 2004 - 2013 Avg. Annual Investment Returns (Net Fees), \$ in Millions			
	Avg. Ann. Returns	<i>If Suburban & Downstate Police & Fire Returns Matched That of IMRF or ISBI...</i>	
		Basis Point Increase	Annual \$ Increase
Suburban & Downstate Police and Fire	5.61%	N/A	N/A
IMRF	7.62%	201	\$288
ISBI	6.73%	112	\$160

Table 5 shows a more recent 5-year investment return average and compares the returns of suburban and downstate police and fire plans to other pension plans in Illinois, besides just IMRF and Illinois State Board of Investment (“ISBI”)-managed assets. Based on the data for this time period, were suburban and downstate police and fire plans to achieve investment returns similar to the other Illinois plans over the next five years, they would create an estimated additional **\$820 million to \$2.5 billion** in investment returns alone, above and beyond the returns they would ordinarily experience.

As the statutorily defined pension ramps are currently constructed, higher returns will ultimately mean a reduction in the required annual employer contribution, and therefore an easing of the burden on taxpayers to pay down the unfunded pension liabilities. While required employer contributions adjust to changes in investment returns, it would be reasonable to inquire how an increase in these returns would impact the overall health of the pension plans if required employer contributions remained unchanged. For the sake of comparison, if the suburban and downstate police and fire plans were to have experienced returns similar to the Illinois Municipal Retirement Fund (IMRF) over the last 5 years, and that additional \$2.5 billion were layered on top of the employer contributions actually made over that time period, the plans would be 10 percentage points better funded today as a result of just those 5 years of improved returns (65% funded instead of 55%).

Table 5: Comparison of Suburban & Downstate Police & Fire Net Investment Returns to All Other Illinois Pension Plans, FY 2012 - 2016

FY 2012 - 2016 Avg. Annual Investment Returns (Net Fees) For IL Pension Systems (\$ in Millions)					
	No. of Plans	5-Yr Avg. Ann. Returns	<i>If Suburban & Downstate Police & Fire Returns Matched That of the Other IL Systems...</i>		
			Basis Point Increase	Annual \$ Increase	5-Yr Total \$ Increase
Suburban & Downstate Police and Fire	649	5.06%	N/A	N/A	N/A
Total All Other Systems in IL	15	6.89%	183	\$262	\$1,360
IMRF	1	8.28%	322	\$461	\$2,460
IL Statewide Systems	5	6.18%	112	\$160	\$820
Chicago Area	6	6.94%	188	\$269	\$1,398
Cook County	3	7.38%	232	\$332	\$1,741

As indicated, the larger pooled systems tend to operate more efficiently in terms of investment fees and expenses than smaller ones. For example, as of FY 2018, IMRF spent \$127 million on direct investment expenses on \$40.8 billion in total assets, for an investment expense-to-assets ratio of 32 basis points. In the same year, ISBI spent \$22 million on direct investment expenses on \$18.4 billion in total assets, for an investment expense-to-assets ratio of 12 basis points. When the Illinois Department of Insurance analyzed the suburban and downstate police and fire pension plans in FY 2013, they found that these plans spent \$65 million on direct investment expenses on \$11.5 billion in assets, for an investment expense-to-assets ratio of 57 basis points. Were these assets pooled and managed similar to the assets of IMRF or ISBI, they would have saved an estimated \$38-\$51 million annually on investment-related expenses alone.⁷

Aside from the difference in the rate of investment returns there is also administrative duplication (e.g. accounting, legal services, auditing, actuarial, training, association fees, travel, etc.) and a potential lack of uniformity in the administration of benefits associated with having 649 individual and independent funds. Further analysis will need to be performed to quantify the costs associated with duplicative administrative efforts across these local pension plans. For instance, all 3,250 police and fire plan trustees are required to take initial training of 32 hours, and annual/reoccurring training of 16 hours. The largest provider of local pension trustee training in Illinois charges local pension plans \$800 to \$1,700 per trustee for initial training and \$465 to \$930 per trustee for annual/reoccurring training. Training of this multitude of trustees costs taxpayers \$3 to \$5 million for initial training and \$1.5 to \$3.0 million annually for reoccurring training. This does not include costs associated with these trainings of travel, lodging, wages, etc.⁸

⁷ Source: 2018 Comprehensive Annual Financial Reports. Note, because IMRF and suburban and downstate police and fire pension plans also administer benefits to pensioners, whereas ISBI does not, general administrative expenses were excluded from this comparison.

⁸ "Public Safety Pension Fund Consolidation: The Benefits to Illinois Taxpayers," March 2017: <https://iml.org/file.cfm?key=15332>

Cook County & City of Chicago Pension Plans

Nine of Illinois' pension plans cover just the areas of Cook County and City of Chicago. With around 100,000 participants, these systems make up 18% of all participants in Illinois' pension plans. Similarly, their plan assets make up 19% of Illinois' total pension assets.

Table 6: City of Chicago and Cook County Pension Plan Funding Levels (\$ in Millions)⁹

Retirement Systems/ Pension Funds by Area:	FY 2016 Unfunded Liability	Increase in Liability from FY 2015	FY 2016 Actuarial Assets	FY 2016 Funded Level
CHICAGO TEACHERS' PENSION FUND	\$9,635.4	0.30%	\$10,610.7	52.41%
COOK COUNTY EMPLOYEES' A&B FUND	\$7,238.2	-0.04%	\$9,488.2	56.73%
MUNICIPAL EMPLOYEES A & B FUND OF CHICAGO	\$10,465.0	6.35%	\$4,590.4	30.49%
POLICEMEN'S ANNUITY AND BENEFIT FUND OF CHICAGO	\$9,804.5	21.02%	\$3,052.1	23.74%
METROPOLITAN WATER RECLAMATION DISTRICT RETIREMENT FUND	\$1,070.9	0.74%	\$1,372.4	56.17%
LABORERS' & RETIREMENT BOARD EMPLOYEES' A&B FUND	\$1,245.6	7.27%	\$1,263.7	50.36%
FIREMEN'S ANNUITY AND BENEFIT FUND OF CHICAGO	\$3,971.0	12.41%	\$1,074.9	21.30%
PARK EMPLOYEES' & RETIREMENT BOARD EMPLOYEES' A&B	\$611.9	18.90%	\$393.6	39.15%
FOREST PRESERVE DISTRICT EMPLOYEES' A&B FUND	\$132.0	2.27%	\$198.2	60.04%
Chicago and Cook total	\$44,174.5	7.69%	\$32,044.1	42.04%
State Total	\$185,192.1	10.10%	\$170,230.5	47.90%

As shown in Table 6, the funds range from nearly \$200 million in plan assets to over \$10.6 billion. The funded ratios for each vary between 20% and 60%. The funded ratio for the Cook County and City of Chicago plans falls below the state average. In FY 2016, no funds significantly decreased their unfunded liability. Instead, most funds saw an increase in unfunded liability. From FY 2012 to FY 2016, the funds experienced a 7.16% investment return, somewhat better than the average for the state.¹⁰

⁹ Source: Illinois Department of Insurance, Public Pension Division, 2017 Biennial Report

¹⁰ Based on Illinois Department Insurance analysis in the spring of 2019, using Comprehensive Annual Financial Reports

Illinois Statewide Pension Systems and Other Pension Plans

In addition to the pension plans addressed above, there are five state-funded pension plans and the Illinois Municipal Retirement Fund (IMRF). Like the five state-funded plans, IMRF serves government employees across Illinois, but the State of Illinois does not have the same obligation to pay benefits to IMRF's pensioners. In addition, IMRF is significantly better funded than the other plans, and has exercised greater ability to order the intercept of state-shared revenue that would ordinarily go to a municipality, if that municipality fails to make a full statutorily required contribution to the pension system in a timely fashion. Altogether, these six plans have approximately 460,000 participants, more than all of Illinois' other plans combined.

Table 7: Statewide Pension Plans (\$ in Millions)¹¹

Retirement Systems/ Pension Funds by Area:	FY 2016 Unfunded Liability	Increase in Liability from FY 2015	2016 Actuarial Assets	FY 2016 Funded Level
TEACHERS RETIREMENT SYSTEM OF ILLINOIS	\$71,407.8	13.91%	\$47,222.1	39.81%
ILLINOIS MUNICIPAL RETIREMENT FUND	\$4,585.3	0.26%	\$43,226.9	90.41%
STATE UNIVERSITIES RETIREMENT SYSTEM	\$23,221.7	3.56%	\$17,701.6	43.26%
STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS	\$29,882.8	14.93%	\$15,632.6	34.35%
JUDGES' RETIREMENT SYSTEM OF ILLINOIS	\$1,675.6	10.97%	\$870.9	34.20%
GENERAL ASSEMBLY RETIREMENT SYSTEM	\$312.5	13.36%	\$50.8	13.99%
Statewide Plans Total	\$131,085.6	9.50%	\$124,704.9	48.75%
Statewide Plans Total except for IMRF	\$126,500.3	11.35%	\$81,478.0	39.18%
All Illinois Pension Plans	\$185,192.1	10.10%	\$170,230.5	47.90%

The average statewide plan has approximately \$21 billion in assets. With \$51 million in assets, the General Assembly Retirement System is the smallest fund. The Teachers Retirement System (TRS) is the largest, holding \$47 billion in assets. Because of TRS' size relative to the other statewide systems, TRS' unfunded liability is more than half the unfunded liability for these six plans combined.

When IMRF is excluded, the statewide systems averaged a 39.18% funded ratio in FY 2016, which is below the average of all Illinois pension plans. This makes Illinois one of the most underfunded for state pension systems in the country. In FY 2016, none of the funds reduced their unfunded liability over the previous year. Instead, most statewide funds' unfunded liabilities grew by at least 10%. From FY 2012 to FY 2016, the five state-funded plans experienced a 6.18% investment return, slightly better than the average all Illinois state and local pension plans.

¹¹ Source: Illinois Department of Insurance, Public Pension Division, 2017 Biennial Report

IMRF's 90% funded ratio is by far the best of all statewide funds, and the return on its investments has surpassed all others over the past five years, leading many to consider it a model plan for best practice comparison.¹²

Recommendation, Step 1: Consolidate Suburban & Downstate Police & Fire Pension Plan Assets

The breadth of the pension issue in Illinois is vast, extending to all areas of the state and to many different public sector workers. From Chicago to Cairo, and from teachers to first responders, the effects of underfunded Illinois pensions negatively impacts state and local finances, and therefore crowds out funding available for other critical public goods and services. The Task Force recognizes that it must make recommendations that will tackle the issue holistically and that also can be effectuated as soon as practicable.

There are a number of facts which underlie the initial recommendation of the Task Force:

- Illinois has more pension plans than all but one other state in the US, and some of the greatest levels of underfunding
- The plan assets in each individual police and fire plan are substantially smaller than most plans nationwide and in the state
- It is extremely inefficient to maintain so many pension plans with so few active participants and such small asset bases
- Unless the investment returns of the police and fire plans are improved, substantial additional contributions from employers and/or employees will be required to make progress on improving funded levels
- Healthy investment returns are vital to public employee pension plan survival, as investment income is required to compensate for cash-flow shortfalls
- The suburban and downstate police and fire pension plans are falling behind in meeting their minimum required investment rates of return
- If these plans were consolidated, they would achieve substantially higher returns and could save the taxpayers in excess of \$160 million on an annual basis

Therefore, the clearest and most compelling initial recommendation of the Task Force is to consolidate the assets of all of the 649 suburban and downstate police and fire pension plans under two new statewide funds—one for police and one for fire. Currently, as separately managed assets, these plans achieve investment returns and investment expense efficiencies far below what they would if they were pooled and managed together. As separate funds, each would have their own board in charge of their own personnel and asset management decisions, and each fund's assets would remain separate from the assets of other statewide pension systems. Consolidated statewide police and fire funds have been achieved in other states, including Ohio, where in 1967, \$75 million in assets and \$490 million in liabilities were consolidated from local public safety funds across the state. As of FY 2018, the Ohio Police and Fire Pension Fund had an investment portfolio of \$15.7 billion and approximately 27,000 active members.¹³

¹² Based on Illinois Department Insurance analysis in the spring of 2019, using Comprehensive Annual Financial Reports

¹³ <https://www.op-f.org/information/aboutopf>

The decision of voluntary versus mandatory pension plan participation in the consolidation was also contemplated by the Task Force. It was determined that mandatory consolidation is the sensible approach as the better performing plans would perform at least as well in the long term under a consolidated model; the worst performing plans would perform substantially better; and greater consolidation would provide greater cost efficiencies to all plans.

Similar to the assets of the existing funds under consolidated management, the suburban and downstate police and fire pension plan assets would be pooled into two separate trusts, one for police and another for fire, for the sake of investment performance, but for accounting purposes would maintain individual and separate accounts for each municipality. On a regular basis each consolidated fund would provide a valuation of total assets, which would be done annually in accordance with the Governmental Accounting Standards Board, and a pro-rata share of each of the trusts' assets will be assigned to each account held by the individual municipalities. The assets and liabilities will remain within the individual local pension plan accounts, such that no assets or liabilities will be shifted from one local plan to another.

With the daily opportunity cost of lost investment returns to the pension plans, the Task Force recommends that there be legislation passed by the General Assembly in the fall of 2019 to provide for this consolidation immediately.

Combining the management of the assets will have the following advantages:

- Achieve economies of scale by minimizing administration costs and investment consulting services fees
- Create better and more efficient asset liability management with respect to short term cash-flow matching
- Create the ability to invest in more diversified, higher return assets to achieve better performing portfolios
- Enhance uniformity in setting investment and other actuarial assumptions
- Provide greater choice in selecting investment vehicles (e.g., equity-related instruments)
- Dramatically reduce the number of asset managers and other service providers to reduce fees and maximize efficiencies
- Monitoring two plans rather than 649 plans would dramatically improve the supervisory efficiency and enable more in-depth review and audit without incurring substantial additional cost by the Department of Insurance

While consolidation of assets will provide the greatest benefit to the plans at this time, the Task Force does recognize some challenges to such action:

- Plan sponsors may feel their influence is being diluted
- Misinformation creates skepticism about the stated advantages of consolidation
- Pushback from asset managers as the savings on investment fees through consolidation mean less money for those managers
- There could be initial costs for transitioning assets into the consolidated asset pool; although this would be substantially less than the upside from stronger investment returns over a matter of a few years
- The change in structure and governance of a consolidated pool will come with typical transition challenges
- Possible objections from better funded pension plans, although underfunded plans will not dilute better-funded plans due to separate account management as previously stated.

Task Force Consideration of Consolidation Under ISBI

The Illinois State Board of Investment (ISBI) currently manages \$18.4 billion in defined benefit assets of the State Employees' Retirement System, the General Assembly Retirement System, the Judges' Retirement System of Illinois, the Illinois Power Agency, as well as the State of Illinois Deferred Compensation Plan.¹⁴ Under current statute, the 9-member ISBI board consists of 5 trustees appointed by the Governor, with the advice and consent of the Senate, who may not hold an elective State office; the State Treasurer; the State Comptroller, as the Chairperson of the State Employees' Retirement System; the Chairperson of the General Assembly Retirement System; and the Chairperson of the Judges Retirement Systems.¹⁵ This role of only administering assets works well with the initial recommendation for only asset consolidation of suburban and downstate police and fire funds. With respect to maximizing the investment returns of these police and fire funds, ISBI has done fairly well at meeting its investment return benchmarks in recent years, but has experienced lower returns on average than IMRF. However, it is still unclear that if the return assumptions between the ISBI and IMRF were similar over the years, how the average returns for each system would compare over the long term; as investment strategy is largely dictated by the assumed investment returns by the systems' boards.

Members of the Task Force voiced several concerns with the consolidation of police and fire assets under ISBI. Those concerns included, but were not limited to, the relationship between state-level retirement systems and the local-level police and fire plans, and the negative connotations of state and local employee asset consolidation. As such, the Task Force agreed that the consolidation of suburban and downstate police and fire assets under ISBI would be abandoned, in favor of separate statewide police and fire funds.

Task Force Consideration of Consolidation Under IMRF

The Illinois Municipal Retirement Fund (IMRF) manages both the assets (\$40.8 billion in assets) and the benefit administration (\$45.4 billion in liabilities) of local government and school district employees outside of the City of Chicago and Cook County.¹⁶ Because the initial recommendation of the Task Force is to consolidate only the assets of suburban and downstate police and fire, IMRF's role in managing only the assets of these plans would be different from its current model. IMRF's strong return on investments makes such a fund appealing for the consolidation of these police and fire funds. Additional appeal of IMRF is that it has much of the existing fund infrastructure in place to quickly expand management to the assets of suburban and downstate police and fire plans. Generally, IMRF would seek to mirror its current investment categories and strategy with the newly consolidated police and fire assets to replicate its successes for these additional \$14 billion in assets. However, since the alternative assets held by IMRF are not always as easily divisible as conventional investment categories, police and fire assets would need to be managed by IMRF in a trust separate from the existing assets until IMRF would be able to replicate the portfolio composition of the existing assets; at which time, the two trusts could be consolidated.

Under current statute, the 8-member IMRF board consists of:

- 4 executive trustees elected by participating units of government

¹⁴ <https://www.isbinvestment.com/>

¹⁵ 40 ILCS 5/22A-109

¹⁶ Source: 2018 Comprehensive Annual Financial Reports

- 3 employee trustees elected by participating IMRF members
- 1 annuitant trustee elected by IMRF annuitants¹⁷

Some members of the Task Force voiced concerns with the consolidation of police and fire assets under IMRF, as well. Ultimately, amending the current IMRF governance structure to accommodate the new suburban and downstate police and fire assets without diluting the representation of existing IMRF employees proved problematic for consensus among the Task Force. It was determined that, while setting up two new statewide police and fire plans would take additional time and resources, it is more amenable than consolidation under IMRF, and far more financially advantageous to these plans than to maintain the status quo with no consolidation.

Task Force Consideration of Consolidation Under a New Police Fund and New Fire Fund

While creating new statewide funds for suburban and downstate police and fire may create some minimal duplication of effort with the other statewide funds and entail some start-up and ongoing costs, it is fairly common practice to differentiate pension systems by the types of members they're serving. Inasmuch as the interests of police and fire personnel are different from other government employees served by existing retirement systems, and different from one another, it would be reasonable to establish separate systems for these employees. In light of the aforementioned challenges with consolidation under existing systems, the Task Force recommends establishing two new statewide police and fire funds that include all existing suburban and downstate funds, with assets consolidated under their own respective trusts and under the purview of separate governing boards. The Task Force recommends setting up board structures to provide equal representation of employees/annuitants and employers on the board of trustees. The Task Force also recommends including two ex officio members to each board—one representative of the statewide association representing participating municipalities (65 ILCS 5/1-8-1) and one representative of a statewide association representing police/fire employees, each with full voting and other rights.

The Task Force recommends each board composition consist of 8 trustees, as follows:

- 3 executive trustees elected by participating municipalities, as defined by Article 7, Section 1 of the Illinois Constitution
- 2 police/fire employee trustees elected by participating police/fire members
- 1 police/fire annuitant trustee elected by police/fire annuitants
- 1 ex officio trustee that is a representative of the statewide association representing participating municipalities (65 ILCS 5/1-8-1)
- 1 ex officio trustee that is a representative of the largest statewide association representing police/fire employees

Note: The Illinois Fraternal Order of Police dissented on this recommended board composition, desiring a board composition with a majority of employee trustees and a minority of employer trustees.

The Task Force also notes that if consolidation of benefit administration for these funds is recommended in the future, that the composition of consolidated fund boards will likely be revisited.

¹⁷ 40 ILCS 5/7-174

The Task Force recognizes that there will be unique challenges from the period of the consolidation legislation becoming effective and the normal board operations of a fully consolidated pool of assets, which may be referred to as the “transition period.” As such, and only for the transition period, it recommends an interim board for each be appointed, with the State Treasurer appointed as a trustee and chair to preside over meetings and only to cast a vote in the event of a tie among the other 8 trustees. The 9-member interim board would consist of the same categories of the aforementioned trustees, but would be appointed by the Governor. The Governor would also appoint an interim executive director.

The Task Force recommends the following timeline for consolidation of assets for each police and fire board:

- July 1, 2020: Effective date of enacting legislation; transition period begins
- Following effective date of enacting legislation:
 - Governor appoints, and terms begin, for interim trustees and the two interim executive directors
 - Interim custodian, actuary, general counsel, independent consultant(s), and auditing firm selected
 - Election and seating of permanent trustees; transition period ends
 - Seating of permanent executive director, selected by the new board (existing executive director may be considered)
 - Selection of permanent custodian, actuary, general counsel, independent consultant(s), and auditing firm (may extend existing contracts)
- By July 1, 2023: Newly consolidated funds are fully operational, assuming at least 80% of existing assets have been consolidated into the trusts, with permanent boards and staff seated.

Final “Step 1” Recommendation: Fix to Tier 2

The Task Force also recognizes that there are some unique Tier 2 benefit issues that are particular to the work of first responders. Among the many changes to the pension plans for state and local government employees hired since 2011, Tier 2 members receive a substantially smaller benefit relative to Tier 1 members (those hired before 2011) and experience a pensionable salary cap that grows at a slower rate. While advantageous to the long-term financial health of the pension systems, these changes have received criticism from Tier 2 members as creating inequity in comparison to Tier 1 members. There have also been significant concerns that the slower Tier 2 pensionable salary cap growth and revised final average salary calculation will be in violation of the “safe harbor” standard of the Internal Revenue Code and Social Security Administration. Some state, county, and municipal employees covered by a public pension plan are not required to pay into the Social Security system; this includes teachers and almost all public safety personnel in Illinois, among others. Generally, the “safe harbor” standard requires that those employees exempted from Social Security receive a retirement benefit from their public pension plan that is at least equal to the benefit they would receive under Social Security, in order to continue being exempted from the program. If the benefits do not wind up being at least equal to that of Social Security, the state and local governments will have to either bring up the level of Tier 2 benefits to meet Social Security, or enroll Tier 2 employees in Social Security and pay the associated contributions retroactively. The annual cost of delaying this safe harbor fix to Tier 2 first responders is substantial, as it compresses great liabilities into a shorter timeframe to be paid down. As such, the Task Force recommends the following changes to Tier 2 benefits be made to make the asset consolidation package as comprehensive as possible:

1. **Surviving Spouse Benefit for Non Line of Duty Death** — Under Tier 1 benefits, surviving spouses of police and fire pension participants were entitled to 54% of final average salary, and if the employee passes away before they are vested, the spouse is still eligible for 54% of the salary at the time of death. When Tier 2 was enacted, Tier 2 spouses became entitled to two-thirds of the pension the deceased was entitled to at time of death, and therefore no pension benefit if the employee has not worked at least 10 years. This change is of particular concern, and unique to, first responders. To ensure surviving spouses are entitled to some benefit in the event of a tragic pre-mature death of a first responder, the Task Force recommends the Tier 1 surviving spouse benefits be reinstated for Tier 2 police officers and firefighters.
2. **Pensionable Salary Cap** — Due to the aforementioned federal safe harbor concerns, for downstate and suburban police and fire employees the Task Force recommends increasing the pensionable salary cap growth (since the enactment of Tier 2 in 2011) from the current lesser of *one-half* the Consumer Price Index (CPI-U) or 3%, to the lesser of CPI-U or 3%. This will attempt to ensure the pensionable salary cap grows quickly enough to avoid non-compliance with the federal safe harbor provision.
3. **Final Average Salary** — Currently under Tier 2, pension benefits are calculated based on the average of the highest 8 of the last 10 years of a member's service. Because of the physical demands of the job for first responders, their years of service tend to be more abbreviated than other public-sector occupations. With this concern and the aforementioned safe harbor concerns, the Task Force recommends police officers' and firefighters' benefits be calculated instead on the average of the highest 4 of the last 5 years of a member's service.

While the fixes to Tier 2 benefits for suburban and downstate police and fire plans will have some associated cost, that cost is minimal in proportion to the improved investment returns resulting from consolidation. On average and over a five-year period, the recommended fixes to Tier 2 benefits are estimated to offset between \$70 and \$95 million of the \$820 million to \$2.5 billion (3-9%) in investment return gains, and avoids a potential and costly safe harbor violation.

Recommendation, Step 2: Review consolidation of suburban/downstate police & fire pension plan benefit administration; review of other state and local plans to determine advantages of consolidation

While much of the focus of the Task Force's initial recommendations have been on the advantages to consolidating assets of suburban and downstate police and fire pension plans, there also may be advantages to the consolidation of the benefit administration of these plans as well. The Task Force does recognize the latter may require a longer discussion with those affected by such a change, particularly the members of the plans themselves. At \$26 billion in actuarial accrued liabilities, as of fiscal year 2017, across these suburban and downstate plans, the stakes are high, both for the financial resources of the plans and taxpayers, and for the life-altering decisions in awarding members certain benefits. With many of these plans in dire financial positions, and with an average funded level of only 55%, both components of assets and liabilities need a thorough review.

The more decentralized the structure is for benefit administration, the greater the cost becomes to administer those benefits, but with perhaps more nuanced information guiding the prevailing decision to offer certain benefits in unique cases. As mentioned prior in this report, the trade-offs for this nuance entail administrative duplication (e.g. accounting, legal services, auditing, actuarial, training, association fees, travel, etc.) and a lack of consistency in decision-making among funds, associated with having 649

individual and independent funds. While the exact cost of these issues is not easily quantifiable, it is likely to have added embedded costs to the plans over time. These hidden costs result in fewer dollars to be invested over time and therefore, ultimately, fewer dollars to pay retirement benefits for plan members.

In looking at the overall cost of administering funds, a system such as IMRF, which administers benefits centrally on behalf of thousands of local government employees, spends an estimated 8 basis points annually as a proportion of total fund actuarial value of assets. Annual administrative costs-to-actuarial value of assets for all Illinois plans, except for suburban and downstate police and fire, equate to an estimated 9 basis points. Suburban and downstate police and fire pension plans on the other hand spend an estimated 19 basis points annually as a proportion of total fund actuarial value of assets.¹⁸ Aside from any potential financial benefit due to changes in benefits awarded under a consolidated model, suburban and downstate police and fire plans could experience in excess of \$14 million annually in savings from administrative costs alone were their costs-to-asset expenditures to fall more in line with the other Illinois systems. That is not to say that consolidation can only entail one centralized benefits administration board, as is the case with other plans in Illinois. It may very well be that some other form of consolidation could occur to preserve local knowledge of unique local cases, while saving on duplicative efforts and increasing consistency in benefit-awarding decisions.

In addition to the review of consolidation of benefit administration, some Task Force members have expressed concerns around the suburban and downstate police and fire funding ramp, which should also be reviewed in “step 2” of the Task Force’s work.

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. For reference, under the Illinois Pension code, the required minimum employer contribution for these plans is calculated each year as a level percentage of payroll sufficient to bring the funded-ratio up to 90% by 2040, and is determined under the projected unit credit actuarial cost method. Beginning in fiscal years after March 30, 2011, any actuarial gains or losses from investment return incurred in a fiscal year is “smoothed” over the following 5-year period. The impact of this amortization schedule generally means dramatic year-over-year increases in required municipal employer contributions (largely funded by property taxes) until a 90% funded-ratio is achieved in 2040, at which time the required contribution drops tremendously. The Task Force recommends reviewing the feasibility of this date, in conjunction with other actuarial changes to help front-load contributions and thereby curb the annual rate of growth in employer contributions. For context, other Illinois pension plans have the following statutorily-required year by which they are to hit 90% funded: 2045 for Illinois statewide systems, 2050 for one of Cook County’s plans, and an average of 2057 for the City of Chicago pension plans.

The 15 other pension systems in Illinois, outside of suburban and downstate police and fire, clearly bear significant financial burdens, with the unique exception of IMRF, which is currently 90% funded. These systems are clearly differentiated from the suburban and downstate police and fire plans in that there may be no immediate discernable and material investment return advantage by further investment fund

¹⁸ Source: FY 2018 IMRF Comprehensive Annual Financial Report and Department of Insurance analysis of all other systems’ financial reporting. Includes total fund administration, as it is difficult to differentiate the administrative costs associated with asset management versus benefit administration.

consolidation. On average, they tend to achieve returns more consistent with other larger systems nationally and do not bear the same restrictions on asset classes as plans with substantially smaller asset volumes. That is not to say, however, that they cannot improve their investment returns, that they cannot invest more efficiently, or that they should not be consolidated in some way. Some form of consolidation of these larger systems may also reduce administrative overhead, create more efficient investment through further economies of scale, and create more consistency and efficiency in the administration of benefits.

The greatest financial issue facing these systems is that the growth in liabilities has been consistently diverging from the growth in assets. A fixed 90% funded level target date, market experiences vastly different from actuarial assumptions, and insufficient contributions into the system, have compressed remaining unfunded actuarial accrued liabilities into a shorter and shorter timeframe. This has led to unsustainable growth in required employer contributions and has consistently increased the burden on state and local government operating revenues.

The City of Chicago pension funds have experienced their own unique financial challenges in recent years that warrant specific considerations with respect to the future work of the Task Force. Their current funded levels and projected growth in required employer contributions means significant changes will need to be made to correct course; which may entail greater efficiencies captured through some level of consolidation. As such, the Task Force and the Governor's Office will continue to work with the City of Chicago on this issue as part of the next phase of this work.

Therefore, it is the recommendation of the Task Force that it continues to review these issues and include them in a final recommendation to the Governor.

Conclusion

The issues surrounding pension funding in Illinois have been decades in the making. Underinvestment, overly optimistic projections, and the required trade-offs with other critical public services all place great pressure on the financial health of retirement systems. The State and local governments are now faced with limited options to remedy these issues. The consolidation of asset management is one way to maximize returns and minimize overhead for these pension plans, and will have the most immediate impact on improving their financial health. Additional review of the administration of plan benefits and the consolidation of larger pension systems in Illinois will require more time to weigh the benefits and costs associated with further consolidation.

Respectfully Submitted,

By: William J. Brodsky

Signature: _____

By: Patrick Devaney

Signature: _____

By: Christine Radogno

Signature: _____

Appendix: Illinois Pension Consolidation Feasibility Task Force Creation & Members

On February 11, 2019 Governor Pritzker announced the creation of the Pension Consolidation Feasibility Task Force to explore and make recommendations for consolidation of pension funds in order to achieve the greatest value for pensioners and taxpayers. Task Force members include:

- William J. Brodsky – Co-Chair, former Chairman and CEO of the Chicago Board Options Exchange (CBOE)
- Pat Devaney – Co-Chair, President of the Associated Fire Fighters of Illinois
- Hon. Christine Radogno – Co-Chair, former Illinois Senate Minority Leader
- Michael Carrigan, President, Illinois AFL-CIO
- Hon. Brad Cole, Executive Director, Illinois Municipal League
- Hon. Karen Darch, Village President, Barrington, IL
- Dan Hynes, – Ex Officio, Deputy Governor for Budget & Economy, State of Illinois
- Tim Kobler, Executive Board Member, Illinois Fraternal Order of Police
- Louis Kosiba, Former Executive Director, Illinois Municipal Retirement Fund
- Cameron Mock, – Ex Officio, Chief of Staff & Senior Fiscal Advisor to the Deputy Governor, Governor’s Office of Management & Budget, State of Illinois