THE GOVERNOR'S PENSION COMMISSION

Pension Reform Report and Recommendations

(including Summary of May 2004 Interim Report)

February 11, 2005

THE GOVERNOR'S PENSION COMMISSION:

PENSION REFORM REPORT AND RECOMMENDATIONS

FOR GOVERNOR ROD BLAGOJEVICH

February 11, 2005

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EXECUTIVE SUMMARY

The Governor's Pension Commission was mandated by Governor Rod Blagojevich to review the financial condition of the State of Illinois' Retirement Systems and make recommendations focused on improving the Systems' financial condition and affordability. The Commission's recommendations do not affect earned pension benefits of current State employees or pension benefits being received by current retirees.

The Commission has studied the causes of the Retirement Systems' current underfunded position, the pension plan provisions, the use of Pension Obligation Bonds, other types of pension plans, alternative funding formulas, and related issues. The Commission established a set of guiding principles for State pension funding. Based on those principles, it developed specific recommendations for changes to State pension plan provisions and pension funding in order to ameliorate the Retirement Systems' poor financial status.

Initial estimates from the Retirement Systems' actuaries and consultants from Deloitte Consulting LLP indicate that implementing some of the Commission's recommendations could reduce the Retirement Systems' actuarial accrued liability in 2045 by $145.5 billion, or 28%, from $521.5 billion to $376.0 billion. Additionally, the total expected State contribution for 2006-2045 could be reduced by $54.2 billion, or 20%, from $275.1 billion to $220.9 billion.

I. INTRODUCTION

The Illinois Retirement Systems currently provide pension benefits to approximately 647,000 members in five retirement systems. Over the past thirty years, the State has funded pensions significantly below necessary contribution levels each year, and has added pension benefits without sufficient dollars set aside to pay for these benefits. The combination of these factors has caused the retirement systems to be in a severely underfunded position. As a result, the State's underfunded pension liabilities are significantly greater than those of any other state, as reflected in the following chart:

State	2003 Unfunded Liabilities ($ millions)	Rank
Texas	$22,613	46th
California	25,545	47th
New York	28,302	48th
Ohio	29,650	49th
ILLINOIS	**$43,104**	**50th**

Source: Wilshire Associates 2004

The State of Illinois issued $10 billion of Pension Obligation Bonds in June of 2003 to reduce its funds' increasing liabilities. Proceeds from the bond sales provided the balance of fiscal year 2003 and 2004 State pension contributions in the amount of $2.16 billion, as well as an additional immediate contribution of over $7.3 billion toward reducing the five public employee retirement systems' unfunded liabilities. The infusion of $7.3 billion on July 3, 2003 reduced the retirement systems' unfunded liability from $43 billion to approximately $34 billion, and increased the funded ratio from 48.6 percent on June 30, 2003 to over 57 percent just three days later.

Despite the positive effects of the $10 billion pension obligation bond revenues on the funding status of the retirement systems, the State pension funds still face grave financial challenges. In fact, Illinois State government's unfunded pension debt is significantly greater than all of the State's bonded debt combined. Governor Rod Blagojevich convened the Governor's Pension Commission in the spring of 2004 in order to address continuing concerns over the long-term liabilities of the State's five pension systems.

II. THE PENSION COMMISSION MANDATE AND HISTORY

Governor Blagojevich's mandate to the Pension Commission is:

> To review the financial condition of the Illinois State Pension Systems and provide recommendations for improving their financial condition. Areas for consideration include:
>
> - The amount and growth of the retirement systems' unfunded liabilities;
> - Current and future employee pension plans and contribution structures; and
> - The effect of the pension funds' financial condition on the State's overall current and future financial condition.
>
> Recommendations should focus on improving the affordability of the State's retirement systems.

The Governor's Pension Commission met six times between April 16 and May 24, 2004, to focus on near-term State funding of pension liabilities. The members of that iteration of the Pension Commission unanimously agreed that an adequate analysis of the

important public policy issue of unfunded State pension obligations must consider benefit and contribution changes as well as funding strategies. However, in the interest of producing timely recommendations on immediate funding issue, and given the Commission's desire not to interfere with on-going collective bargaining negotiations, it was decided to issue an interim report on near-term funding strategy in May 2004.[1]

III. CURRENT COMMISSION MEMBERSHIP

Membership in the Governor's Pension Commission (the "Commission") consists of the following individuals:

- The Honorable Roland Burris, Interim Chair, is a partner in Burris, Wright, Slaughter & Tom, LLC has held numerous offices in Illinois including Comptroller and Attorney General;
- *****Representative Mark Beaubien represents Illinois' 52nd District and is the Budget Negotiator for the House Republicans;
- Representative Rich Bradley represents Illinois' 40th District and is the Chairman of the House Personnel and Pensions Committee;
- Senator Bill Brady represents Illinois' 44th District and is the Minority Spokesperson of the Senate Insurance and Pensions & Investments Committees;
- Andy Davis is Chairman and CEO of Rock Island Company of Chicago, and the Vice-Chairman of the Chicago Stock Exchange;

[1] A summary of the Interim Report is attached in Appendix A.

- Ronald Denard is Vice President of Finance and Administration at SoftSheen-Carson, a L'OREAL USA Company;
- Eric Langshur is President and Chief Executive Office of TLContact Inc. and the former President of Bombardier Aerospace CAS;
- *Representative Bob Molaro represents Illinois' 21st District and was Chairman of the former Pension Laws Commission;
- Laurence Msall is President of The Civic Federation;
- Ronald Powell is President of United Food and Commercial Workers #881 and Vice President of United Food and Commercial Workers International;
- Gerald Roper is President and Chief Executive Officer of the Chicagoland Chamber of Commerce;
- *Senator Jeff Schoenberg represents Illinois' 9th District and is Chairman of the Senate Appropriations II Committee, Vice Chairman of the Senate Appropriations III Committee and is Co-Chair of the Commission on Government Forecasting and Accountability (former IEFC); and
- Paula Wolff is a Senior Executive at Chicago Metropolis 2020.

* Denotes current members of the Commission on Government Forecasting and Accountability (formerly Illinois Economic and Fiscal Commission).

IV. STRUCTURE OF THIS REPORT

The next five sections of this report outline the Commission's analysis and recommendations. Section V provides an overview of the pension systems and the causes of the current underfunding situation. Section VI details the principles that guided

this Commission's work. Section VII discusses the Commission's recommended changes to pension plan provisions and Section VIII discusses the Commission's recommended changes to pension funding. The Commission also reviewed the use of Pension Obligation Bonds, other types of pension plans and alternative funding formulas, which are discussed in Sections IX and X.

V. OVERVIEW OF THE PENSION SYSTEMS AND FUNDING PROBLEMS

The Retirement Systems of Illinois consist of five distinct plans, which have accrued liabilities of approximately $90 billion as of June 30, 2004. Three of these plans represent over 98% of the State's pension liabilities: the Teachers' Retirement System ("TRS"), State Universities Retirement System ("SURS") and the State Employees' Retirement System ("SERS"). As of June 30, 2004, TRS accounted for $50.9 billion in estimated liabilities ($19.4 billion of which was unfunded); SURS $19.1 billion ($6.5 billion of which was unfunded); and SERS, $18.4 billion ($8.4 billion of which was unfunded). The other two plans, the General Assembly Retirement System ("GARS"), $0.2 billion ($0.1 billion of which was unfunded) and the Judges Retirement System ("JRS") $1.2 billion ($0.6 billion of which was unfunded), have generated relatively small obligations. State funding payments are currently determined by the 1995 funding law described below and the 2002 Early Retirement Incentive ("ERI") program.

The 1995 Funding Law

By 1995, the retirement systems' unfunded liability had grown to approximately $20 billion. Public Act 88-593 (the "1995 law") made a number of changes to public

employee pensions, the most significant of which was the adoption of a funding schedule. The General Assembly established a funding ratio objective of 90% of liabilities for the State funded retirement systems, to be achieved by 2045. From FY2011 through FY2045, the required contribution would be a level percent of payroll required to reach 90% funding by FY2045. For FY1996 through FY2010, the contribution percent would increase in equal increments to the rate required in FY2011.

The Causes of the Current Underfunding Situation

The Commission has identified and analyzed several factors and their relationship to the current underfunding of the State pension systems, noting the following:

- For each of the past thirty years, annual State contributions have been less than the necessary amount (the interest and current costs) determined by the retirement systems' actuaries. Since 1995, and through June 2003, the contribution shortfall totaled $10.6 billion. This increased the amount of underfunding;
- The State increased pension benefits by $5.8 billion since 1995, and through June 2003, without introducing sufficient funding to pay the related costs. This also increased the amount of underfunding;
- The employees within the various State pension systems have met their obligations by paying the contributions as determined in accordance with the Illinois Pension Code;
- Since 1995, and through June 2003, the State pension funds experienced investment losses of $6.4 billion;

- After implementation of the 1995 law, annual funding decisions adhered to a fixed, ramped-up payment schedule, but did not adjust for the cyclical opportunity provided by the long 1990s economic expansion to contribute in excess of the fixed payment amounts provided for in the 1995 funding law; and
- State pensions were under-funded in an exceptionally strong economic environment, while benefits – most notably, costly increased benefits included in the 2002 Early Retirement Incentive program and, also, enhanced benefits formulas – were added. A downturn in the economy followed the expansion, and pension systems' earnings declined while costs of new benefits increased.

As a result of the above, the unfunded liability grew to $43 billion by June of 2003. Additional factors that contributed to the growth in unfunded liabilities include:

- The gradual extension by the State of the Alternative (enhanced) Formula to approximately 5,380 employees brought the total number of employees covered by the Alternative Formula to 24,845, thus increasing liabilities;
- Significant market upturns since 1995 followed by downturns resulted in reduced investment returns, thus increasing unfunded liabilities; and
- The 2002 Early Retirement Initiative increased liabilities and certified contributions.

VI. GUIDING COMMISSION PRINCIPLES

The Commission emphasized that pension funding decisions should be consistent with fundamental values of the people of Illinois and the capacity of the State economy to prosper, adopting the following principles:

- The State must fully honor its pension obligations;
- Under no circumstance should pension payments be deferred;
- The availability of State revenues is impacted by the stages of the business cycle, and pension funding decisions should be adjusted accordingly;
- Pension funding decisions must take into account the feedback between those decisions and Illinois' economic growth;
- Pension-funding choices should not damage State creditworthiness and its capacity to raise funds in capital markets**.** Unfunded Illinois pension benefits are real state liabilities that directly impact the State's creditworthiness and are greater than the State's bonded debt for all other purposes;
- The State pension systems are currently significantly underfunded. State government must address this issue;
- Any new benefits must have new funding sources to support them when enacted;
- Changes should be designed to simplify the systems and be applied equally to all systems where applicable that are the responsibility of the State of Illinois;
- Changes must be in compliance with Illinois' Constitutional provisions regarding pension benefits;
- The use of Pension Obligation Bonds must be limited to alleviating past underfunding;
- Local employer pension enhancement decisions that impact state resources must adhere to principles incorporated in State law and be paid for by the employing entities; and

- An on-going Pension Commission should be created, staffed by the Governor's Office of Management and Budget, to serve as a review mechanism for all suggested changes to pension laws.

VII. CHANGES IN PENSION PLAN PROVISIONS

When reviewing potential changes to employee pension plans, the Commission felt it important to again note that the current underfunding is not the fault of the State employees -- the employees within the various State pension systems have always paid their contributions in accordance with the Illinois Pension Code. To that end, the Commission's recommendations do not affect earned pension benefits of current State employees or pension benefits being received by current retirees.

Although the Commissioners agree with the conclusions of various actuaries that many of the basic benefits to State employees under the pension systems are comparable with national public retirement systems norms, there are certain provisions that are not consistent with general public retirement system practices. Therefore, the Commission recommends consideration of the following changes to pension plan provisions. Estimated savings attributable to pension plan changes below are included in Appendix B. These changes could reduce the Retirement Systems' actuarially accrued liability in 2045 by up to $145 billion and reduce the total expected State contributions between FY2006 through FY2045 by up to $54 billion:

1) The General Assembly must not adopt any new pension benefit without a new funding source identified at the point of adoption. In addition, an explicit sunset provision must be attached to any new pension benefit;
2) For purposes of State pension liability, pay increases in the final average period of employment should be limited as determined by the Governor and the General Assembly, unless fully funded by the local employer or employee. A possible limitation on pay increases in the final average period of employment for purposes of pension liability would be limited to 5%;
3) Eliminate the money purchase pension plan option under SURS, for new hires only;
4) Define more precisely the rate of interest applied to the current money purchase option under SURS. Using the long-term rate of return, but not to exceed the most recent five-and ten-year rates of return, reduce the interest rate on money purchase for current participants to 6%;
5) Increase the eligibility requirements for new employees to receive unreduced benefits by changing the minimum age to 65 with 8 years of service;
6) Limit automatic annual pension increases for new hires only to 2%, limited to the first $12,000 of annual pension for members covered by Social Security and $24,000 for members not covered by Social Security;
7) Limit employee groups eligible for Alternative (enhanced) Retirement Formula benefits, for new hires only to Sworn Police Officers only;
8) Increase the employee contribution rate for those employees receiving alternative retirement formula benefits; and
9) Increase employee contributions to the SERS, SURS, TRS, JRS and GARS by 1%.

Additional options can be found in Appendix C. Estimates of these options have not been provided as of the date of this report. Upon receiving estimates, the Commission may issue a supplemental report regarding these options.

VIII. CHANGES IN PENSION FUNDING

The Commission recommends that the 1995 law be revisited and analyzed for potential revisions, and that any changes to the 1995 law should be reviewed annually. When crafting the 1995 legislation, the members of the General Assembly along with the actuaries were making assumptions 50 years into the future. Additionally, the 1995 law stated that that law would be reviewed and adjusted every five years.

As a result, the Commission urges that if the General Assembly were to implement the $52 billion in savings identified in Section VII, or some significant portion thereof, the Commission would support the following changes to the 1995 law. It is critical to note, however, that under no circumstances does the Commission support disregarding any payments into the State pension systems.

Specific options, recommendations and observations for changes in funding include:

1. The 1995 funding plan should be amended to reflect the $146 billion reduction in accrued liabilities $54 billion in reduced State contributions resulting from the recommended pension plan changes outlined in the previous section.

2. Consistent with the 1995 funding plan, the revised funding plan should incorporate the following principles:
    a. Reflect the 1995 funding plan's goal of a 90% funded ratio by 2045;
    b. Provide for a ramping of contributions to a constant percent of payroll by 2011 (and including the 2002 ERI amendment to the 1995 funding plan); and
    c. Provide for continuing appropriation authority for pension contributions.
3. Any savings produced by the proposed pension plan changes, or any significant portion thereof, should be proportionately allocated for the required contributions from 2006 through 2045, and should parallel to the existing funding structure. Reflecting the pension plan changes and savings recommended in this report, and applying the guidelines in paragraphs 1 and 2 above, the Commission hereby recommends the attached representative example of the revised funding plan presented as Appendix D.

IX. PENSION OBLIGATION BONDS

In 2003, Pension Obligation Bonds ("POBs") were issued to help fund the State pension systems. Notwithstanding anything else in this report, the Commission recommends that the issuance of additional POBs be explored as a viable option contingent upon the following:

- POBs should not be issued until and unless there are structural changes made to the pension plans similar to those recommended in Section VII of this report ; and
- All POB proceeds should be used to reduce the unfunded liability.

The Commission presents two possible uses of POBs:

- To correspond with the amount and duration of the liability created by the Early Retirement Initiative of 2002; and
- To reduce unfunded pension obligations if market conditions are favorable and would sustain such an issuance.

X. ADDITIONAL TOPICS FOR ANALYSIS

The Governor's Pension Commission continues to study the concepts of defined contribution plans and dynamic scoring, described below. It is also gathering data to estimate the financial impact of those options listed in Section XII for which savings estimates were not yet available. The Commission will forward its findings to Governor Blagojevich when they become available.

Defined Contribution Plans

The Commission considered an option recommending that the State replace all or part of its current Defined Benefit plans with Defined Contribution plans. However, the Commission strongly believes that this concept will require additional study. Defined contribution plans can significantly reduce unfunded liabilities. Once the State gets the current pension debt levels under control, a Defined Contribution Plan should be strongly considered in the near term for newly hired employees and current employees who voluntarily opt out of defined benefit programs.

Alternative Funding Formulas

Capital and population are mobile, seeking their most advantageous location, especially within an area with a common currency. Illinois, as a result, is in constant competition

with other States for jobs and economic growth. State fiscal policy choices must take into account the feedback between its tax and spending decisions and economic growth.

In the 1990's, when the Illinois economy was strong and revenues were robust, the State failed to direct additional revenues towards the underfunding of the State pension systems to remedy the problem and close the underfunding gap. The Commission heard testimony and discussed principles relating to structuring a mechanism to ensure that there is an overfunding of the State pension systems when the Illinois business cycle is more prosperous. Diane Swonk, Chief Economist of Mesirow Financial and former Chief Economist of Bank One twice appeared before the Pension Commission to discuss the Principle of Dynamic Scoring.

Ms. Swonk explained that overfunding of the pension systems should occur during robust economic times to counter less funding during periods of an economic downturn. However, Ms. Swonk withheld endorsing specific triggers that should precipitate the State's overfunding of the systems. The Commission agrees that the Governor and the General Assembly should make pension funding decisions which are adjusted if and when revenues are impacted by the stages of the business cycle. However, specific economic triggers that would result in the funding adjustments should be explored further. When State revenues exceed the previous year's revenues, the State should utilize a prescribed percentage to pay more into funding the pension systems. Conversely, it is critical to establish a funding floor so that a minimum amount is always contributed towards the systems, even during down economic periods.

Finally, Mr. James Hacking, Executor Director of the State Universities Employment System, introduced a reserve concept similar to the State's Rainy Day Fund. Mr. Hacking's reserve concept basically stated that if, just prior to the start of any state fiscal year the estimated general funds revenues for the next succeeding state fiscal year exceed the current fiscal year's estimated general funds revenues by more than 4%, then a portion of that amount of the general funds revenues, reduced by any amount that is required by law to be transferred to the Budget Stabilization Fund, shall be distributed to the five state contributory retirement systems.

APPENDIX A

The May 2004 Interim Report of the Pension Commission made the following recommendations:

> The proposed FY2005 budget funds $2 billion of the $2.5 billion mandated State payment to the pension funds out of general revenue. To fund the remaining $0.5 billion FY2005 obligation, ten out of the eleven total members of the Commission identified four options that can be used singly or in combination:
>
> - Use part of the better-than-expected present-value savings that resulted from the extraordinarily beneficial market interest rates when the 2003 Pension Obligation Bonds were sold;
> - Execute another Pension Obligation Bond program to take advantage of market interest rates that are still significantly below expected longer-term asset yields;
> - Reschedule the funding mandated in the Early Retirement Incentive program to make it more in line with other State pension funding; and/or
> - Fund the remaining contribution out of general revenues.

Note: Commissioner Laurence Msall filed a dissenting report relating to the May 2004 Interim Report, however, he fully supports the Commission's overall findings as reflected in this consolidated February 11, 2005 Pension Reform Report and Recommendations.

APPENDIX B

CHANGES IN PENSION PLAN PROVISIONS

Options Selected for Consideration

Draft estimates have been provided by the Retirement Systems' actuaries and consultants from Deloitte Consulting LLP. Both the total accrued pension liability reductions ($145 billion) and total expected State contribution reductions ($54 billion) are as stated in Section VII of the Report for the below combination of options. However, the actuaries and consultants caution that the individual draft projections for each of the below recommendations are interdependent upon one another and will vary depending on which combination of recommendations are adopted. Therefore, the individual draft projections for each of the below recommendations are presented for illustrative purposes only, while the total liability reductions and contribution reductions remain as stated in Section VII of the Report. In addition, variations of those changes will not necessarily produce similar results.

1) The General Assembly must not adopt any new pension benefit without a new funding source identified at the point of adoption. In addition, an explicit sunset provision must be attached to any new pension benefit;

2) For purposes of State pension liability, pay increases in the final average period of employment should be limited as determined by the Governor and the General Assembly, unless fully funded by the local employer or employee. Possible limitations on pay increases in the final period of employment include:

   Limit increases to 5%. This is estimated to reduce accrued liabilities in the year 2045 by $19.47 billion, and to save $16.20 billion in State contributions.

3) Eliminate the money purchase pension plan option under SURS, for new hires only. This is estimated to reduce accrued liabilities in the year 2045 by $4.73 billion, and to save $1.18 billion in State contributions;

4) Define more precisely the rate of interest applied to the current money purchase option under SURS. Options include:

   Use the long-term rate of return, but not to exceed the most recent five-and ten-year rates of return. For example, reducing the interest rate on money purchase for current participants to 6% is estimated to reduce accrued liabilities in the year 2045 by $2.25 billion, and to save $5.47 billion in State contributions.

5) Increase the eligibility requirements for new employees to receive unreduced benefits. Options include:

   Change the minimum age to 65 with 8 years of service. This is estimated to reduce accrued liabilities in the year 2045 by $30.90 billion, and to save $11.51 billion in State contributions.

6) Limit automatic annual pension increases for new hires only. Options include:

   Automatic annual pension increase of 2%, limited to the first $12,000 of annual pension for members covered by Social Security and $24,000 for members not covered by Social Security. Reducing the automatic annual increase to 2% for new hires only is estimated to reduce accrued liabilities in the year 2045 by $74.20 billion, and to save $4.76 billion in State contributions.

7) Limit employee groups eligible for Alternative (enhanced) Retirement Formula benefits, for new hires only. Options include:

   Sworn Police Officers only. This is estimated to reduce accrued liabilities in the year 2045 by $13.96 billion, and to save $1.36 billion in State contributions.

8) Increase the employee contribution rate for those employees receiving alternative retirement formula benefits; and

9) Increase employee contributions to the SERS, SURS, TRS, JRS and GARS by:

   1%. This is estimated to save $13.72 billion in State contributions between 2006 and 2045.

APPENDIX C

CHANGES IN PENSION PLAN PROVISIONS

Additional Options for Consideration

1) For purposes of State pension liability, pay increases in the final average period of employment should be limited as determined by the Governor and the General Assembly, unless fully funded by the local employer or employee. Additional possible limitations on pay increases in the final period of employment include:

   - Limit increases to 3%.
   - Limit increases for employees with 25-30 years of service to the actual average salary increase for all employees over that time period.
   - Limit increases to the lesser of Consumer Price Index or 5%.

2) Define more precisely the rate of interest applied to the current money purchase option under SURS. Additional option includes:

   Use the long-term rate of return, but not to exceed either of the two most recent five-year rates of return.

3) Increase the eligibility requirements for new employees to receive unreduced benefits. Additional options include:

   - Change the minimum age to 62 with 30 years of service.
   - Change the minimum age to 60 with 35 years of service.
   - Change the minimum age to that age at which the member qualifies for an unreduced Social Security benefit.

4) Limit automatic annual pension increases for new hires only. Additional options include:

   - Automatic annual pension increase matches the Consumer Price Index or some comparable index, but is no higher than 4% and no lower than 1%, limited to the first $12,000 of annual pension for members covered by Social Security and $24,000 for members not covered by Social Security.
   - Automatic annual pension increase of 60% of CPI or some comparable index but no greater than 3%, limited to the first $12,000 of annual pension for members covered by Social Security and $24,000 for members not covered by Social Security.

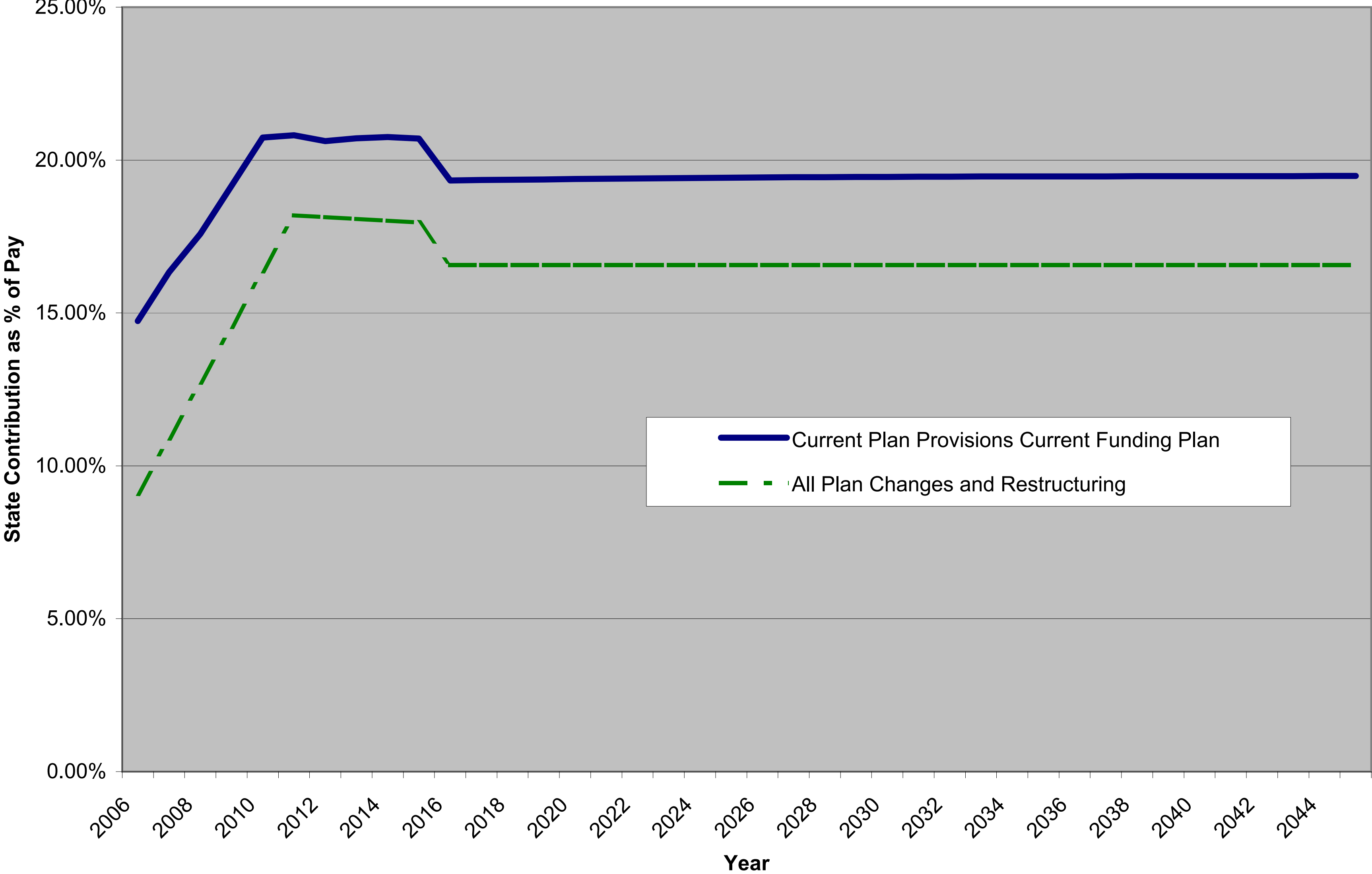
5) Limit employee groups eligible for Alternative (enhanced) Retirement Formula benefits, for new hires only. Additional option includes:

Sworn Police Officers and others only if the recipient pays the full additional costs;

6) Increase employee contributions to the SERS, SURS, TRS, JRS and GARS by:

- ½% per year for the next four years.
- ¼% per year for the next two years.
- 5% of applicable rate (e.g., 8% becomes 8.4%)
- Adjust increased employee contributions to reflect the actual increased cost of underlying benefits.

Estimates of these options have not been provided as of the date of this report. Upon receiving estimates, the Commission may issue a supplemental report regarding these options.


Appendix D-1
State Contribution
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
State Contribution as % of Pay
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
2026
2028
2030
2032
2034
2036
2038
2040
2042
2044
Year
Current Plan Provisions Current Funding Plan
All Plan Changes and Restructuring

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February 9, 2005

Commission Members:

First, let me reiterate my view that I believe the full commission should have voted on the main body of the commission's report. If we had been given the opportunity to vote, I would have voted against the report. These comments detail my opposition to the report.

On January 28, 2005, I voted to forward to the Governor and General Assembly for their consideration and examination various pension benefit changes that had been discussed but not fully agreed upon by the commissioners. I agree information should be forwarded to the Governor and General Assembly. I personally do not support the benefit changes as explained below. Detailed below is my opposition to the savings plan which I voted against at our meeting February 4, 2005. I believe this plan amounts to borrowing now from questionable savings at the expense of our children and grandchildren. Also detailed below are my thoughts on bonding and other issues.

Benefit Changes

It is my belief that the recommendations generally diminish benefits for new hires and violates numerous existing agreements between the State and its employees. Our State has negotiated with its employees, over the course of numerous years, a compensation package that encompasses everything from health insurance coverage, pension benefits, salary and salary increases, to life insurance coverage. It is my view that the State has a certain amount of money that it can utilize to fund this compensation package and by entering into an agreement with the employees, the State obligates itself to fund each element by the agreed upon terms.

Teachers, represented by their unions, have worked to create a retirement formula and a mechanism to fund that formula through years of negotiating. The retirement benefits negotiated for the teachers of our State were agreed upon by the members of the General Assembly, the Governor, and the members of that critical profession.

If this Administration wishes to avoid its responsibilities to fund our pension obligations, the Administration should have negotiated ways to alter those pension benefits by

agreeing upon different terms than contained in the accepted union contracts and should have communicated with all parties involved in the negotiating of benefits for teachers. Now that I have explained my philosophy, it should be clear why I cannot support recommending enacting the following changes or any related suggested options:

- Reducing cost-of-living raises on pension benefits for new hires from the current 3% to 2%.
- Raising the full retirement age for new hires from 60 up to 65.
- Limiting the alternative formula eligibility for new hires.
- Increasing employee contributions for pensions.
- Eliminating the "money purchase" formula for new hires and fixing the interest rate on the formula for existing employees.

Needed Reform

The end-of-career salary increases for superintendents do need to be addressed.

The 1995 Formula

I do not agree that we should change the formula adopted in 1995 if we are not improving it. It's shortsighted for us to reduce our contributions in the short run, and push the costs onto our children and grandchildren. There is no compelling, fiscally sound reason to lower our current goal of reaching 90% funding, or to stretch that out another 20 years into the future – going from 2045 to 2065.

I oppose changing the 1995 formula to create any plan to "recognize" future savings that may (or may not) occur under long-term reforms. That's just another attempt to allow the Governor to avoid systemic budget changes and address Illinois' lagging job creation. No matter how you spin it, we would simply be spending money now that we don't (and may never) have. The responsible course is to recognize savings **only** in the years in which those savings actually occur. To build a proposed budget – or to enact a budget – that under funds our pensions today, in hopes of receiving savings sometime in the future, is the height of irresponsibility. It's especially irresponsible to under fund pensions using "savings" that rely on reforms that have not passed and are probably not going to pass the General Assembly.

But, let's suppose that some of these reforms would happen to pass. Even then, the savings depend on the unlikely assumption that future legislators will not restore these benefit cuts at some point over the next 30-40 years. There are simply too many variables in these assumptions to serve as a sound foundation for today's state budgets. We have no accurate idea now how many future employees we will have in future years, what their salaries may be or how our investments will perform over the next 30-40 years. In fact, the loss of investment earnings from short-term underfunding could erase any savings from reforms that could occur. What is being proposed is not unlike the neglect of our predecessors whose underfunding of the pension systems led to our pension pressures

today. I believe it is poor public policy to "cash in" today on the long-term bet that these savings will indeed occur.

What we can guarantee, though, is that if we rush to spend these paper "savings" on expanded government spending, we will take on new costs and **never** see the savings materialize. We will only be digging ourselves a deeper hole. The **only** responsible course is to use any savings that do occur to whittle down our $35 billion in unfunded pension liabilities (the largest among any of the 50 states). Spending future savings today does nothing to cure this $35 billion albatross.

Bonding

I oppose bonding to fund the 2002 early-retirement liabilities unless the bonding is done strictly under the conservative conditions recommended by the Commission on Government Forecasting and Accountability (formerly the Illinois Economic and Fiscal Commission). Those conditions include a maximum bond repayment schedule of 10 years and compliance with our "debt responsibility" law. That will require level-principal payments. We must also require that 100% of any bonds should be competitively bid to eliminate the perception or reality of the possibilities of undue influence and corruption. Additionally, as recommended by the forecasting commission and discussed by this commission, all proceeds of any bonding should be directed to the pensions system and not used for the general state budget. (We already have had considerable budget relief from the almost $600 million in annual payroll costs that were eliminated with the early retirements.) Short of this type of responsible bonding plan, I believe we should cash fund this early retirement liability over the next 10 years or less.

I object to any plan to bond current-year contributions to allow increased government spending, as the State did with the $10 billion 2003 bonding program. I have not been persuaded that any bonding can be structured responsibly to bond any sizable portion of our $35 billion unfunded liability. In any event, reforms should not be used as a carte blanche to do more bonding that locks in undue burdens on future taxpayers and our children and grandchildren.

Dynamic-scoring principle or alternative funding

I concur with the recommendation to consider the dynamic-scoring principle (now called alternate funding formulas), though I believe we should only use this principle to drive increased contributions to our pension systems, and not as yet another excuse to under fund pensions below our current formula.

Defined-contribution plan

I have long advocated creating a defined-contribution plan. A defined-contribution plan offers the opportunity to lower and stabilize both the State's and employees' contributions, while offering employees a plan that allows personal responsibility, flexibility and portability. We should explore both a required defined-contribution plan

for new employees and an optional plan for existing and new employees. I understand that there would be some short-term added costs to the State with a new defined-contribution plan if newly hired employees were required to join the defined-contribution plan, or if substantial numbers of existing or new employees joined an optional defined-contribution plan. But I believe the long-term rewards to both the State and the employees may be worth the immediate costs to the State and merit detailed consideration.

Conclusion of Employee Represented Organizations

As a member of the labor community in Illinois, I applaud the Governor for convening the Pension Commission to focus on near-term State funding of pension liabilities. I believe we have identified key problems in addressing the future of each of the five State-funded pension plans and debated a number of scenarios that will assist the State in meeting its promises and obligations to its workforce. However, in solidarity with the working families employed by the State of Illinois, I cannot support the recommendations set forth by this Commission.

First and foremost, State employees in the five State employee pension funds have upheld their responsibility under the Pension Code by making their required contributions. Unfortunately, for the past thirty years, the State has not. In addition, through the collective bargaining process, State employees have agreed to higher pension contributions, wage freezes and an end to cashable sick leave to gain and maintain adequate pension benefits upon retirement. In addition, educators have previously agreed to higher contributions in the cost of upgrading their past service to gain pension improvements.

I appreciate that the report adopted by the Commissioners stressed numerous times that the current under-funding of the State pension plans is not the fault of State employees. Unfortunately, the solutions adopted by this Commission will in fact impact the very people who have already fulfilled their obligations.

In Exhibit A of the report, there is a recommendation that pay increases in the final average period of employment should be limited as determined by the Governor and the General Assembly unless fully funded by the local employer or employee.

Scenario A & B limits the pay increase to 3% and 5% respectively. This is unworkable for state employees represented by the Building Trade Unions and receiving the Prevailing Rate. These employees have no control over annual pay increases. Likewise, non-Prevailing Rate employees through the collective bargaining process could also receive pay increases in excess of 3%. While these employees vote to accept or reject the collective bargaining agreement, wages, like benefits, are negotiated rather than set arbitrarily. The problem of certain recipients receiving huge pay increases near retirement is isolated and most often managerial employees. There is no reason why all State employees should be penalized for the actions of a select few.

In a similar instance, wage increases and cost of living increases for members of the General Assembly and the Judiciary branch are set by the Compensation Review Board and cannot be lowered by either the General Assembly or Judiciary. Often times, one Chamber of the General Assembly has rejected the recommendations of the Compensation Review Board, only to have the other Chamber vote to accept the Report thereby granting pay increases to all participants in the plan. The pension benefits these participants receive should be based on their final period of employment. It is what they have legally earned.

The State should not implement a two-tier pension system for new hires. As a proponent of an equal days pay for an equal days work, it is unconscionable for labor to accept two workers doing the same job while one receives less compensation. A two-tier pension system for new hires is patently unfair. This would include a lower cost of living adjustment (COLA) than current plan participants receive. This scenario also includes the prohibitions of new hires from participating in the money purchase option under the State Universities Retirement System.

While labor agrees that sworn police officers should benefit from being enrolled in the Alternative Formula, we also believe that a number of State employees work under equally hazardous conditions. The danger is not any greater for an employee working as a barber, an electrician or an instructor in a State correctional facility than it is for

correctional officers. All employees working in a State correctional or developmental center face the same inherent dangers day in and day out. This danger does not distinguish employees by date of hire. . In addition, if the General Assembly and the Governor recognizes that other positions in the State are inherently more dangerous; future Governors and members of the General Assembly should have the latitude to recognize these dangers and place these workers in the Alternative Formula.

Increasing the employee contributions is the most unfair recommendation of all. The burden of adequately funding the pension plans should not fall on the very people who have been identified in this report as meeting their obligations.

This report makes numerous recommendations to the Governor and General Assembly that include different options to consider. Yet, one option that is not considered is the option of increased revenue to adequately fund the pension systems. For decades, in both good and bad economic times, the State did not fulfill its pension funding obligations. And now, the State is seeking reduced benefits, a two-tier system for new employees, and increased pension contributions by the very people who have loyally fulfilled their responsibilities.

Although this report recommends further study for Defined Contribution Plans, employee represented organizations will oppose any departure from the Defined Benefit Plan currently in use. It is true that many private industry employers have moved away from offering employees defined benefit pensions and instead offer Defined Contributions Plans as a means of retirement savings. However these plans are more risky and less secure due to volatility in the stock market and retirement benefits not being guaranteed.

In the past, some public employers have attempted to negotiate lower retirement contribution rates. But if this is allowed to occur, even for new hires, it will completely alter the stability of any of the programs. If the employer contribution level is lower, eventually the benefit levels will be too.

The various entities of labor organizations who represent State employees, teachers and university professionals know and understand that Illinois has a crisis in funding its pension obligations. We are also aware that this unfunded liability has a direct bearing on the State's creditworthiness. However, we believe that the State has made a promise through collective bargaining and legislation to its employees and educators and these promises should be kept. We believe that the only way to fully achieve the goal of 90% funding by 2045 is to fund a level percentage of payroll.

Simply, we believe that a promise made should be a promise kept.

Respectfully submitted.

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UFCW International Vice President