Commission on Government Forecasting and Accountability

703 Stratton Ofc. Bldg., Springfield, IL 62706

MONTHLY BRIEFING FOR THE MONTH ENDED: NOVEMBER 2016

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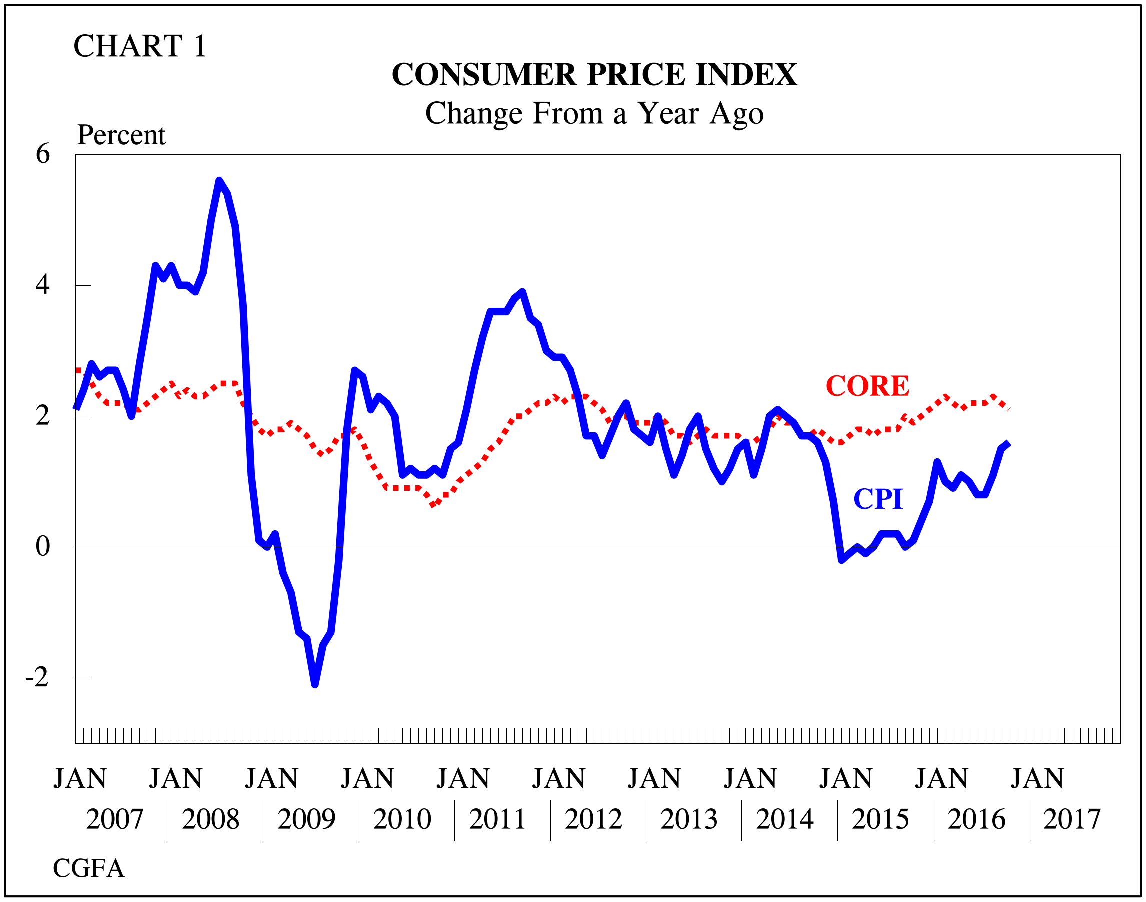
ECONOMY: Return of Fiscal Policy

Edward H. Boss, Jr., Chief Economist

After years of depending on the Federal Reserve through monetary policy to stimulate the economy that has been the weakest economic recovery since the end of WWII, it appears that fiscal policy may take its place. Economists agree that dependence on monetary policy through the manipulation of interest rates operates with a significant lag whereas fiscal policy, through cutting taxes and/or increasing government spending, has a more direct economic impact. The problem with implementing fiscal policy instead of relying on monetary policy was that the national debt had doubled in recent years and there was no agreement on tax reform.

Indeed after years of targeting zero to near zero interest rates, the policy did little to lift economic growth. Indeed in the first three quarters of 2016, the economy grew at a 1.8% annual rate, the slowest since 2013. Even with improvement expected in the final quarter, GDP growth is likely to be around 2%, making it the weakest growth in all but 2 of the past 7 years. Moreover, savers, particularly the elderly, have been punished by a low return on their C/Ds and treasury securities while pension fund investments returned well below that assumed by actuaries. Recent improved economic reports coupled with the removal of uncertainty surrounding the elections appear to have set the stage for beginning to further normalize interest rates by raising the federal funds rate an additional ¼% by year's end.

The Federal Reserve had set guidelines as to what it wanted to achieve before it would stem its accommodative policy – an unemployment rate reduced to 5% and inflation at 2%. The unemployment rate for November was 4.6% and has been at 5% or below for 14 consecutive months. Many would argue that, given the lower labor force participation rate, it is higher. They point to the U6 measure that includes those marginally attached to the labor force and working part-



time for economic reasons which currently stands at 9.3%. Even so, this unemployment measure has slowly come down from a high of 17% when the recovery from the recession began.

As shown in the above chart, overall consumer prices in October were up 1.6% from a year earlier while the core rate, which excludes the volatile food and energy sectors, was up 2.1% from a year earlier where it had been at or slightly above 2% since November of last year. The Federal Reserve relies more on what is termed the PCE or personal consumption expenditures which is more expansive and tied in more closely to GDP. Latest data show that the PCE was up 1.0% from a year earlier while the PCE excluding food and energy was up 1.7% from a year earlier and had not been higher since the final quarter of 2012.

The emphasis on the consumer in assessing GDP growth is that it accounts for about 70% of expenditures. Thus, the upward revisions to retail sales last month, coupled with forecasts of a 3.6% increase in holiday sales projected by the National Retail Federation, compared to a ten-year average of 2.5%, augers well for further improvement. The latest reading of the University of Michigan's Consumer Sentiment Index at 93.8, the highest since July, adds credence to rising confidence coupled with the sharp postelection record-setting movement of the stock market. The optimism is thought to emanate from promises of policies that would reduce tax rates, the prospect of returning vast sums of U.S. corporate funds held abroad, a reduction in the amount of restrictive regulations, as well as proposals for increasing spending on infrastructure.

Should these actions lead to acceleration in economic growth on a sustained basis, additional increases in key monetary policy interest rates would follow and prices would likely rise further. Such developments would not be discouraged initially by the monetary authorities. Down the road, however, the money supply has been rising at a rapid pace and, as pointed out by the St. Louis Federal Reserve Bank, the velocity or turnover of money has been decreasing since 2007. This means consumers and firms are holding on to cash instead of spending it, reflecting low inflation and lack of confidence in the recovery. As confidence is restored the velocity should pick up and when coupled with sharply rising supply of money will begin to put upward pressure on prices. Since monetary policy operates with a significant lag, the Federal Reserve will have to be alert so as to avoid rapidly rising prices which once taken hold are difficult to reverse.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS *	October 2016	Sept. 2016	October 2015
Unemployment Rate (Average)	5.6%	5.5%	5.9%
Annual Rate of Inflation (Chicago)	0.8%	0.1%	0.8%

	Latest Month	% Change Over Prior Month	% Change Over A Year Ago
Civilian Labor Force (thousands) (October)	6,564.4	0.0%	0.6%
Employment (thousands) (October)	6,197.8	-0.1%	0.9%
NonFarm Payroll Employment (October)	6,022,600	2,200	29,500
New Car & Truck Registration (October)	50,089	-10.1%	-9.9%
Single Family Housing Permits (October)	1,113	9.9%	9.2%
Total Exports ($ mil) (September)	4,852.5	-2.8%	-7.0%
Chicago Purchasing Managers Index (November)	57.6	13.8%	18.3%

* Due to monthly fluctuations, trend best shown by % change from a year ago

REVENUE
November Revenues Weak As Concern Grows
Jim Muschinske, Revenue Manager

Overall base revenues fell $159 million in November largely due to yet another extremely low federal source receipting month. While personal income tax managed to post decent gains for the month, they were offset by feeble performance of corporate income tax and weak sales tax revenues. November had the same number of receipting days as the previous year.

Gross corporate income taxes fell by $41 million for the month, or $36 million net of refunds. The new ledger accounting system at IDoR continues to result in dramatic shifts in receipt patterns, making interpretation of monthly receipts very challenging. The Department has indicated that the new system's ability to "work returns" and make reconciliations is more timely and accurate than the previous accounting system. However, at least initially, receipts have diverged significantly from expectations, creating uncertainty as we move closer to the larger months of final payments. Sales taxes also underperformed in November with receipts falling $23 million. One explanation of the drop may be associated with some "slippage" of receipts into the first day of December. Inheritance tax receipts declined by $7 million, corporate franchise taxes dropped $2 million, while insurance taxes dipped $1 million.

Despite the disappointment in corporate income and sales taxes, gross personal income tax fared much better, growing $75 million, or $58 million net of refunds and diversions to the Fund for Advancement of Education and Commitment to Human Services Fund. Public utility taxes were up $12 million, interest income $2 million, and cigarette and vehicle use taxes each eked out a $1 million advance.

Other sources were up $94 million for the month due to a one-time $84 million repayment from SERS reflecting a prior year overpayment to that retirement system. The last time such a repayment occurred was in FY 2014 [in an amount of $59 million].

Overall transfers experienced a $5 million decline in November. The lottery transfer grew $1 million and all other miscellaneous transfers were up $9 million, but those gains were more than offset by a drop of $15 million in riverboat transfers. As mentioned, federal sources experienced another extremely weak month, falling $253 million below last year, reflecting lower reimbursable spending from the general funds.

Year To Date

With almost half of the fiscal year completed, base receipts are down $607 million through November. Last month's briefing mentioned concern with FY 2017 revenue performance—that concern continues to grow. Unfortunately, the weakness is in the largest revenue sources such as income and sales taxes, thereby limiting the State's ability to engage in reimbursable spending, resulting in very poor federal source performance.

Gross corporate income taxes are off $297 million, or $260 million net of refunds. Gross personal income tax, despite a good November, is still down $96 million or $144 million if refunds and diversions to the education and human service funds are included. As mentioned, sales taxes are weak and have fallen $1 million. Overall transfers are down $79 million to date. Only the one-time nature of this month's SERS repayment has allowed other sources to post a $103 million increase.

With a dramatic falloff in federal sources in November, receipts are behind last year's dismal pace by $200 million. Growth will have to increase dramatically over the remainder of the fiscal year even to hit the Commission's very modest projection.

GOMB FY 2017 REVENUE REVISION

In late October, the GOMB released a five-year budget forecast which contained an updated FY 2017 revenue estimate. The following table depicts the differences between the GOMB's revised forecast and the Commission's July estimate. As shown, the Commission remains lower in the estimates of all of the major revenue categories. In total, the differences equate to $1.028 billion. When the income tax revenues diverted to the Fund for the Advancement of Education and Commitment to Human Services Fund are included, the differential grows further to $1.052 billion.

FY 2017 General Funds Forecast
CGFA [July-16] vs. GOMB [Nov.-16]

($ millions)	CGFA	GOMB	Difference
Income Taxes [Net]	$14,785	$14,912	($127)
Sales Tax	$8,215	$8,220	($5)
All Other State Sources	$3,177	$3,223	($46)
Transfers In	$1,606	$1,747	($141)
Federal Sources	$3,100	$3,809	($709)
Total	$30,883	$31,911	($1,028)
Including Revenues to the:			
Fund for Advancement of Education	$461	$473	($12)
Commitment to Human Serviced Fund	$461	$473	($12)
Total General Funds & FAE/CHFS	$31,805	$32,857	($1,052)

It must be mentioned that the GOMB's estimate of federal sources continues to assume spending and subsequent reimbursement for Medicare premiums under the Medicaid program. However, the State actually utilizes an "off-set" mythology with the feds regarding these Medicare premium payments, and has for a number of fiscal years. [This is assumed under the Commission's federal source estimate]. While the overall budget impact is neutral between the "spend/reimburse" vs the "off-set" method, the impact to federal sources is approximately $500 million. ***So, a true "apples to apples" comparison would require an approximate reduction of $500 million from the GOMB federal source estimate. In doing so, the difference between the forecasts would fall to approximately $525-$550 million, depending if the FAE/CHSF funds are included.***

NOVEMBER
FY 2017 vs. FY 2016
($ million)

Revenue Sources	Nov. FY 2017	Nov. FY 2016	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$965	$890	$75	8.4%
Corporate Income Tax (regular)	2	43	($41)	-95.3%
Sales Taxes	625	648	($23)	-3.5%
Public Utility Taxes (regular)	75	63	$12	19.0%
Cigarette Tax	29	28	$1	3.6%
Liquor Gallonage Taxes	14	14	$0	0.0%
Vehicle Use Tax	3	2	$1	50.0%
Inheritance Tax	20	27	($7)	-25.9%
Insurance Taxes and Fees	1	2	($1)	-50.0%
Corporate Franchise Tax & Fees	18	20	($2)	-10.0%
Interest on State Funds & Investments	3	1	$2	200.0%
Cook County IGT	56	56	$0	0.0%
Other Sources	123	29	$94	324.1%
Subtotal	$1,934	$1,823	$111	6.1%
Transfers				
Lottery	51	50	$1	2.0%
Riverboat transfers & receipts	29	44	($15)	-34.1%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	0	0	$0	N/A
Fund sweeps	0	0	$0	N/A
Other	42	33	$9	27.3%
Total State Sources	$2,056	$1,950	$106	5.4%
Federal Sources	$106	$359	($253)	-70.5%
Total Federal & State Sources	$2,162	$2,309	($147)	-6.4%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($108)	($87)	($21)	24.1%
Corporate Income Tax	($1)	(6)	$5	-83.3%
Fund for Advancement of Education	($31)	(33)	$2	-6.1%
Commitment to Human Services Fund	($31)	(33)	$2	-6.1%
Subtotal General Funds	$1,991	$2,150	($159)	-7.4%
Short-Term Borrowing	$0	$0	$0	N/A
Interfund Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$1,991	$2,150	($159)	-7.4%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 1-Dec-16

GENERAL FUNDS RECEIPTS: YEAR TO DATE FY 2017 vs. FY 2016 ($ million)				
Revenue Sources	**FY 2017**	**FY 2016**	**CHANGE FROM FY 2016**	**% CHANGE**
State Taxes				
Personal Income Tax	$5,265	$5,361	($96)	-1.8%
Corporate Income Tax (regular)	355	652	($297)	-45.6%
Sales Taxes	3,399	3,400	($1)	0.0%
Public Utility Taxes (regular)	349	346	$3	0.9%
Cigarette Tax	147	146	$1	0.7%
Liquor Gallonage Taxes	73	73	$0	0.0%
Vehicle Use Tax	15	15	$0	0.0%
Inheritance Tax	121	163	($42)	-25.8%
Insurance Taxes and Fees	109	100	$9	9.0%
Corporate Franchise Tax & Fees	91	91	$0	0.0%
Interest on State Funds & Investments	11	8	$3	37.5%
Cook County IGT	56	56	$0	0.0%
Other Sources	265	162	$103	63.6%
Subtotal	$10,256	$10,573	($317)	-3.0%
Transfers				
Lottery	278	258	$20	7.8%
Riverboat transfers & receipts	138	147	($9)	-6.1%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	0	77	($77)	-100.0%
Fund sweeps	0	0	$0	N/A
Other	260	273	($13)	-4.8%
Total State Sources	$10,932	$11,328	($396)	-3.5%
Federal Sources	$877	$1,077	($200)	-18.6%
Total Federal & State Sources	$11,809	$12,405	($596)	-4.8%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($581)	($523)	($58)	11.1%
Corporate Income Tax	($62)	($99)	$37	-37.4%
Fund for Advancement of Education	($173)	($178)	$5	N/A
Commitment to Human Services Fund	($173)	($178)	$5	N/A
Subtotal General Funds	$10,820	$11,427	($607)	-5.3%
Short-Term Borrowing	$0	$0	$0	N/A
Interfund Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$125	($125)	-100.0%
Total General Funds	$10,820	$11,552	($732)	-6.3%

SOURCE: Office of the Comptroller, State of Illinois: Some totals may not equal, due to rounding.

CGFA 1-Dec-16

October and November 2016 Bond Sales and Latest Downgrade

Lynnae Kapp, Senior Analyst

BOND SALES

In November 2016, Illinois sold $480 million in competitive General Obligation bonds with a true interest cost of 4.245%. The spread on the 10-year maturity reached 200 basis points over the MMD benchmark. There were eight bidders on the GOs.

Also in November, the six Letters of Credit on the October 2003B $600 million Variable Rate GO bonds were to terminate (November 27, 2016) and would have been subject to mandatory tender. On November 7, 2016, the State entered into new agreements with four purchasers with new terms and an expiration date of November 7, 2018. In addition, Illinois renegotiated three of the five swap agreements and negotiated two new agreements, while also lowering the ratings levels that would trigger a swap termination. Under the previous agreements if the State went below BBB/Baa2 rating level, it would trigger the swaps to default. Under the new agreements, the State's rating would have to go below BBB-/Baa3 for termination, except for with Deutsche Bank which has agreed to lower the termination rating to below BB+/Ba1, giving the State more leeway. [See Illinois' General Obligation Ratings History table at the end of this section]

For the October 2016 bond sale the State sold $1.3 billion in GO Refunding bonds. The ten-year maturity was 193 basis points above the Municipal Market's AAA benchmark, soon after a 1-level downgrade by Standard & Poor's. The State insured the final three years of maturities (2030-2032). Present value savings of $106 million came from lowering the average rate of the bonds being refunded from 4.96% to 3.70%, shortening the maturity by two years. The bonds were able to gain additional savings due to Public Act 99-0523, which loosened current restrictions on GO and Build Illinois refunding bonds sold in FY 2017, such as on the length of maturities and the annual required redemption amounts.

Illinois competitively sold $549 million of Build Illinois bonds in September 2016. There were four series of bonds sold:

- Series A $150 million of tax-exempt project bonds for Illinois Jobs Now;
- Series B $60 million of taxable project bonds for Build Illinois projects;
- Series C $152 million of tax-exempt Refunding bonds for Build Illinois projects; and
- Series D $187 million of tax-exempt Refunding bonds for Illinois Jobs Now projects.

Present value savings on the refunding portions equaled approximately $56 million. The true interest cost for the overall deal was 2.442%. Build Illinois bonds are backed by the sales tax and receive higher ratings than Illinois' GO bonds from S&P (AAA) and Fitch (AA+); Moody's was not asked to rate these bonds. Each series received a minimum of nine bids, and with low interest rates, the State's penalty was minimized, with the 10-year yields at 48 basis points over the Municipal Market Data’s AAA benchmark. [*Why Illinois’ High-Grade Paper Was an Easier Sale Than GOs*, The Bond Buyer, August 25, 2016; *Illinois Sets Senior Management Pool*, The Bond Buyer, September 23, 2016.]

BOND SALES								
DATE	BOND SALE TYPE	AMOUNT	TAXABLE v. TAX-EXEMPT	NEGOTIATED v. COMPETITIVE SALE	TRUE INTEREST COST	S&P	FITCH	MOODY’S
FY 2014								
Jun/Jul-13	General Obligation bonds	$1.3 billion	tax-exempt	negotiated	5.042%	A-	A-	A3
Dec-13	General Obligation bonds	$350 million	taxable	competitive	5.397%	A-	A-	A3
Feb-14	General Obligation bonds	$1.025 billion	tax-exempt	negotiated	4.063%	A-	A-	A3
Mar-14	Build IL	$402 million	taxable	competitive	4.271%	AAA	AA+	A3
Apr-14	General Obligation bonds	$250 million	tax-exempt	competitive	4.082%	A-	A-	A3
May-14	General Obligation bonds	$750 million	tax-exempt	negotiated	4.096%	A-	A-	A3
FY 2016								
Jan-16	General Obligation bonds	$480 million	tax-exempt	competitive	3.999%	A-	BBB+	Baa1
Jun-16	General Obligation bonds	$550 million	tax-exempt	competitive	3.743%	BBB+	BBB+	Baa2
FY 2017								
Sep-16	Build IL 2016A	$150 million	tax-exempt	competitive	2.442%	BBB+	BBB+	Baa2
	Build IL 2016B	$60 million	taxable					
	Build IL 2016C Refunding	$152 million	tax-exempt					
	Build IL 2016D Refunding	$187 million	tax-exempt					
Oct-16	General Obligation Refunding	$1.3 billion	tax-exempt	negotiated	3.7616% Discount Rate	BBB	BBB+	Baa2
Nov-16	General Obligation bonds	$480 million	tax-exempt	competitive	4.245%	BBB	BBB+	Baa2

The State sold $550 million in General Obligation bonds in June of 2016, after lowered bond ratings from two ratings agencies (see following page). Illinois had ten bids and received a true interest cost of 3.7425% even with its widest spread yet--185 basis points for the 10-year prices over the Municipal Market Data’s AAA benchmark. Market participants stated that Illinois priced its bonds at the perfect time, when the wide spreads were countered by historically low interest rates. “The market is flush with cash and an infusion of global interest against a backdrop of record low interest rates that have investors in search of income opportunities…’For investors looking for yield this is relatively attractive’.” [*Illinois Reaps Benefit of Market Timing*, The Bond Buyer, June 20, 2016]

In the State's Build Illinois deal in March 2014; it received seven bids on the $402 million taxable issue with JPMorgan winning the bonds with a true interest bid of 4.2706%. While the sales tax-backed bonds were subject to an interest rate penalty for the Illinois name, the higher ratings shielded them from the steeper penalties spreads imposed on the state's stressed GO paper. The spreads ranged from 25 basis points to 105 basis points to comparable Treasuries, below the spreads of well over 100 basis points on its GOs to comparably rated GOs throughout the scale. [*Illinois Returning to Market with Sales Tax Bonds*, The Bond Buyer, August 10, 2016]

The State sold General Obligation bonds in January 2016 for $480 million, which had been the first bond sale in 20 months. Bond ratings had been lowered a few months before that sale, by all three ratings agencies. Interest rate penalties at that time were expected to be high, but with a drop in demand for stocks and an increase in demand for high yield bonds, the State received a true interest cost of 3.9989%. This rate [was] lower than the last competitive sale in April 2014 of 4.082%, even though the state's spreads were wider, due to a lower interest rate environment. [*Munis Weaken as BAML Wins 4480M Illinois GOs*, The Bond Buyer, January 15, 2016]

SEPTMBER 2016 AND JUNE 2016 DOWNGRADES BY MOODY'S AND S&P

Standard and Poor's lowered Illinois' GO bond rating from a BBB+ to BBB with a negative outlook in September 2016, after lowering the State from A- in June 2016. "The 'BBB' rating reflects our view of the state's: Long history of structural imbalance and a governmental framework that limits the state's ability to curb its spending in absence of an adopted budget; Top leadership's highly polarized views on how to address Illinois' fiscal imbalance, which has left the state without a fully adopted budget for a second year, and which continues to impede progress on fiscal realignment; Large projected operating deficit of approximately $6 billion, which could lead to pressure on liquidity and increased payables that could rise to up to $11 billion by fiscal year-end 2017, absent a budget compromise; Large net pension liability for its five pensions systems, which stood at $116 billion (40.2% funded) on a Governmental Accounting Standards Board (GASB) Statement 68 basis, and which is expected to increase based on weak market returns over the past two years with limited likelihood of pension reform following the May 8, 2015 ruling that the state's pension reform efforts are unconstitutional and confirming the pension protections contained in Illinois' constitution; and Moderately high debt burden."

S&P said they could still lower the State's rating further if the State does not adopt a budget and deal with its structural issues and liabilities. The rating agency also states that Illinois' ability to pay debt service could become compromised and the State is "particularly susceptible to any unanticipated economic stress or revenue underperformance…Additional downside pressures on the rating include the potential need to make accelerated debt payments on its variable-rate debt should the state fail to extend the letters of credit or face a swap termination event due to a rating trigger."

On June 8, 2016, Moody's Investors Service downgraded Illinois' General Obligation Bonds and Build Illinois Bonds one level from Baa1 to Baa2. "The rating downgrade reflects continuing budget imbalance due to political gridlock that for more than a year has kept Illinois from addressing revenue lost due to income tax cuts that took effect in January 2015. The state's structural budget gap equals at least 15% of general fund expenditures, if the state's underfunding of pension contributions is included. If this gap continues into a significant portion of the coming fiscal year, it will put pressure on operating fund liquidity and add to an already sizable bill backlog. We project that the backlog will surpass prior peak levels (about $10 billion) in coming months, in the absence of a consensus on a budget that offsets the loss of revenue from the 2015 tax cuts. The potential for economic underperformance or unplanned liquidity demands heightens the risk of further financial weakening. Illinois benefits from a large and diverse economic base, legal provisions that ensure continued payment on debt even with no enacted budget, and powers common to US states, such as freedom to increase revenues or constrain spending. However, the long-running partisan standoff is impeding Illinois' ability to exercise these powers or to make progress addressing unfunded retiree benefit liabilities that far exceed those of other states."

At the end of September 2016, Fitch Ratings reaffirmed its BBB+ rating on negative watch, but plans to review credit ratings in January when the General Assembly plans to return to work on the State budget.

TABLE 14 ILLINOIS' GENERAL OBLIGIATION RATINGS HISTORY

Date of	*Fitch*		*S&P*		*Moody's*	
Rating Action	*Rating*	*up/down*	*Rating*	*up/down*	*Rating*	*up/down*
September 2016			*BBB*	↓1x		
June 2016			*BBB+*	↓1x	*Baa2*	↓1x
October 2015	*BBB+*	↓1x			*Baa1*	↓1x
June 2013	*A-*	↓1x			*A3*	↓1x
Jan 2013			*A-*	↓1x		
Aug 2012			*A*	↓1x		
Jan 2012					*A2*	↓1x
Jun 2010	*A*	↓1x			*A1*	↓1x
Mar-Apr 2010	*A-/A+ recal*	↓1x/↑2x			*Aa3 recal*	↑2x
Dec 2009			*A+*	↓1x	*A2*	↓1x
Mar-Jul 2009	*A*	↓2x	*AA-*	↓1x	*A1*	↓1x
Dec 2008	*AA-*	↓1x				
May 2003	*AA*	↓1x			*Aa3*	↓1x
Jun 2000	*AA+*	↑1x				
Jun 1998					*Aa2*	↑1x
Jul 1997			*AA*	↑1x		
Feb 1997					*Aa3*	↑1x
Sep 1996	*AA*	*initial rating*				
Feb 1995					*A1*	↓1x
Aug 1992			*AA-*	↓1x	*Aa**	↓1x
Aug-Sep 1991			*AA*	↓1x	*Aa1*	↓1x
Mar 1983			*AA+*	↓1x		
Feb 1979			*AAA*	*initial rating*		
1973					*AAA*	*initial rating*

Note: "recal" means recalibration, when Fitch and Moody's revised their ratings on municipal bonds to match global/corporate ratings. These are not considered upgrades.

***Moody's rating of Aa was before that level had moifiers of Aa2 and Aa3, so it was considered one level inbetween AA1 and A1**

Agency Ratings Comparison	
Fitch/S&P	**Moody's**
AAA	Aaa
AA	Aa2
AA-	Aa3
A+	A1
A	A2
A-	A3
BBB+	Baa1
BBB	Baa2
BBB-	Baa3
BB+	Ba1
BB	Ba2
BB-	Ba3
B+	B1
B	B2
B-	B3
CCC+	Caa1
CCC	Caa2
CCC-	Caa3
CC	Ca
C	C

PENSIONS

Report on the 90% Pension Funding Target of P.A. 88-593

Dan Hankiewicz, Pension Manager

Pursuant to 40 ILCS 1-103.3, every five years, the Commission on Government Forecasting and Accountability must consider and determine whether the 90% funding ratio set forth in P.A. 88-593 continues to represent an appropriate goal for the State-funded retirement systems (P.A. 88-593 is commonly known as "the 1995 pension funding law"). This determination must be made in consultation with the State-funded systems and with the Governor's Office of Management and Budget. Accordingly, CGFA staff has asked our consulting actuary, Segal, to provide an opinion on the 90% funding target. Segal's letter, along with letters from the State systems and the Governor's office, appear on the following pages.

SEGAL

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November 4, 2016

Via E-Mail

Dan R. Long
Executive Director
Commission on Government Forecasting and Accountability
703 Stratton Office Bldg.
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Re: **Opinion on 90% Funding Target under Illinois Pension Code**

Dear Dan:

As required by ILCS Sec. 1-103.3(c), we are writing to provide our opinion as to whether the 90% funding ratio under the Illinois Pension Code statutory funding policy represents an appropriate goal for State-funded retirement systems in Illinois. We believe that the 90% funding ratio goal, along with the actuarial methods used to determine the statutory funding contributions, is **not** an appropriate goal and recommend that a funding policy be adopted that will provide for adequate funding of the Illinois plans that provide for funding based on this 90% target.

Funding Adequacy

The employer contribution rates are determined in accordance with the funding policy specified under the Illinois Pension Code. The employer contributions are determined such that, together with the member contributions, the plans are projected to achieve 90% funding by 2045. The 2045 funding objective of 90% was set in 1994 as a 50-year objective. The members of each system have always contributed their share. The State funding has been inadequate resulting in the Illinois plans being among the worst funded public employee retirement systems in the United States. We strongly recommend an actuarially sound funding policy that targets 100% funding.

Funding Policy

A funding policy outlines the parameters for calculating an actuarially determined contribution rate and ensures the systematic funding of future benefit payments. An actuarially determined contribution is comprised of the Normal Cost and an amortization of the Unfunded Actuarial Accrued Liability. These amounts are determined by the three funding policy components:

- *Actuarial Cost Method*: The Actuarial Cost Method allocates the total present value of future benefits to each year (Normal Cost) including all past years (Actuarial Accrued Liability or AAL)

- *Asset Smoothing Method*: The techniques that spread the recognition of investment gains or losses over a period of time for the purposes of determining the Actuarial Value of Assets used in the actuarial valuation

- *Amortization Policy*: The method on how, in terms of duration and pattern, to fund the Unfunded Actuarial Accrued Liability

Historical Underfunding by the State

The Illinois Pension Code sets the parameters for funding the Illinois plans. The employer contributions are determined such that, together with the member contributions, the systems are projected to achieve 90% funding by 2045. The 2045 funding objective of 90% was set in 1994 as a 50-year objective.

The State has historically underfunded the systems by the use of funding policies that do not provide for adequate funding and include:

- Establishing a 50 year period in 1994, over which to amortize the Unfunded Actuarial Accrued Liability

- Back loading the 50 year period by requiring a 15 year period to ramp up to contributions

- Setting a funding target of 90% of the actuarial accrued liability (as opposed to 100%)

- Requiring the use of the projected unit cost method, which further back loads the contributions as compared to the entry age cost method, which is a level cost funding method

- Imposing a maximum contribution based upon Pension Obligation Bond (POB) debt payments

- Reducing contributions for fiscal years ended June 30, 2006 and 2007

- Modifying the asset valuation method to reduce contributions for the fiscal year ended June 30, 2011; further reducing FY 2011 contributions by requiring the systems to recertify the 2009 valuation to assume that Tier II had been in effect in 2009

- Requiring that the Tier II benefit provisions be fully reflected in the determination of the contribution before the reduction in benefit payments occurs, resulting in reduced contributions

Summary

We strongly believe that the 90% funding ratio goal, along with the actuarial methods used to determine the statutory funding contributions for the Illinois pension plans, is **not** an appropriate goal. We recommend that a funding policy be adopted that will provide for adequate funding of the Illinois plans.

Please let us know if you have any questions.

Sincerely,

Matthew A. Strom

Matthew A. Strom, FSA, MAAA, EA
Vice President and Actuary

cc: Mr. Dan Hankiewicz
Ms. Kim Nicholl

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STATE RETIREMENT SYSTEMS

December 17, 2015

Senator Donne Trotter
Co-Chairman, COGFA
627 State House
Springfield, IL 62706

Representative Donald Moffitt
Co-Chairman, COGFA
217-N Stratton Building
Springfield, IL 62706

Dear Senator Trotter and Representative Moffitt:

Effective August 22, 1994, Public Act 88-0593 ("the Act") established a targeted funding ratio of 90% of assets to liabilities for each of the state funded retirement systems by June 30, 2045 and required annual maintenance of this funding ratio beginning on July 1, 2045. The Act also called for the targeted funding ratio to be reviewed every five years in consultation with the systems and the Governor's Office of Management and Budget.

We continue to strongly recommend raising the targeted funded ratio to 100% of assets to liabilities. The 1994 law established a targeted funding ratio of 90% because it was the average funded ratio for public retirement systems at the time. However, the actuarially-determined funding goal for those retirement systems was 100% at that time, as it is today. The Illinois retirement systems stand in agreement with the public sector retirement community and the actuarial profession when we urge full funding of all of the benefits our members have earned.

We note that public sector retirement funding standards have become more stringent since 1994. For example, amortization periods shorter than 30 years are recommended for eliminating unfunded liabilities. Earlier funding, in addition to targeted funding ratio of 100%, would make the retirement systems more secure and would substantially reduce financing costs due to interest accruing on the unfunded liability, the primary driver of state contribution requirements.

Beginning in 2012, pursuant to Illinois law, the state actuary has reviewed and commented on the work performed by the actuaries of the state-funded pension systems. In every instance, they have found the assumptions used by our actuaries in their calculations to be reasonable. The state actuary also agrees that the required state contribution calculated each year complies with Illinois statutes. More significantly than these positive findings, the state actuary has noted annually that Illinois funding law mandates inadequate funding and that its provisions do not follow Actuarial Standards of Practice. They, along with us, strongly urge that the law be changed to require funding of 100% of the accrued liability based on generally accepted actuarial principles each and every year.

We would be happy to discuss these issues with you or your staff at any time.

Very truly yours,

W. Bryan Lewis
Executive Director
State Universities Retirement System

Timothy B. Blair
Executive Secretary
State Retirement Systems

Richard W. Ingram
Executive Director
Teachers' Retirement System

cc: Dan Long, Commission on Government Forecasting and Accountability
William G. Holland, Auditor General
Mike Noble, Cheiron

OFFICE OF THE GOVERNOR
207 STATE HOUSE
SPRINGFIELD, ILLINOIS 62706

BRUCE RAUNER
GOVERNOR

Senator Donne Trotter
Co-Chair, CGFA
627 State House
Springfield, Il 62706

Representative Donald Moffitt
Co-Chair, CGFA
217-N Stratton Building
Springfield, Il 62706

Dear Senator Trotter and Representative Moffitt:

When signed into law in 1994, Public Act 88-593 created a pension funding schedule paid over 50 years starting in 1995 and culminating with a goal of 90 percent funded in 2045. Unfortunately, the funding schedule contained a 15 year phase-in period, lasting until 2010, with insufficient contributions that have resulted in a substantial increase in the unfunded liability for the state's pension systems.

Any changes to the funding ratio goal of 90 percent would have an immediate impact on the state's budget. A decrease in the goal would result in slightly lower payments but a higher unfunded liability in 2045. It would also impact Illinois credit worthiness and be inadvisable as the long-term costs would be significant. An increase in the goal would result in higher payments now, but a reduction in unfunded liability in the system. Given the current fiscal pressures facing the state and the pension systems' recent changes in assumptions resulting in higher contributions from the state, this too is inadvisable without significant reforms to the pension systems.

Therefore, at this time, the 90 percent funding ratio continues to be an admirable and achievable goal for the State of Illinois' pension systems.

Regards,

Michael Mahoney
Senior Advisor for Revenue and Pensions