Commission on Government Forecasting and Accountability

Report on the Recommendations for Funding the 2002 SERS Early Retirement Incentive Program

January 2005
703 Stratton Office Building
Springfield, Illinois 62706

Commission on Government Forecasting and Accountability

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INTRODUCTION

Public Act 93-0839 required the Commission on Government Forecasting and Accountability (***formerly the Illinois Economic and Fiscal Commission***) to hold one or more hearings to review recommendations related to the funding of the 2002 SERS ERI. The Commission addressed the ERI funding issue at public meetings held on November 9, 2004 and January 10, 2005. This report contains the funding alternatives identified by the Commission and provides the Commission's recommendation on the alternative that should be used to fund the 2002 SERS ERI liability.

EXECUTIVE SUMMARY

Public Act 93-0839 requires the Commission on Government Forecasting and Accountability to hold one or more hearings to review recommendations related to the funding of the 2002 SERS ERI. The Commission is to file a report with the General Assembly "making its recommendations relating to funding of early retirement incentives under this Section; the Commission's report may contain both majority recommendations and minority recommendations." This report provides the SERS ERI funding alternatives discussed at required meetings of the Commission on Government Forecasting and Accountability.

This report discusses the four possible ERI funding options and the effect of those options on the required FY 2006 State contributions to SERS.

Current Law

Under current law the State is required to amortize slightly more than $1.9 billion in liability over 10 years beginning in FY 2006. The statutory interest rate to be used in the calculation of the amortization payments is 8.5%, which is the assumed investment return of SERS. The resulting ERI payment is $280.5 million annually, beginning in FY 2006. This is the only ERI funding option that would not require a legislative change.

Changing the Amortization Period Within SERS

The current ERI funding provision could be changed so the liability is funded over a period of longer than 10 years. Essentially, the State could extend the period in order to reduce the annual cost. The interest rate would remain at 8.5%. If the amortization period were extended to 20 years, the annual ERI payment to SERS would total $202.7 million, or $77.8 million less annually through 2015 than current law. But, as the annual payments under this alternative would continue until FY 2025, total contributions would be about $1.25 billion more than those required by current law.

No Separate ERI Funding

If the ERI liability were rolled back into the current regular SERS funding plan, the ERI liability would be funded over the remainder of the current fund plan (40 years) like the rest of the SERS unfunded liabilities. According to SERS, the required FY 2006 ERI contribution would be only $21.5 million if it were funded over 40 years, or $259 million less than required by current law. In fact, the contributions to SERS for the ERI would be very low for the first several years after the change was made. Then, as the end of the funding plan approaches, the required ERI contributions to SERS become significantly greater than if funded according to current law. Under this scenario, ERI contributions over the remainder of the funding plan would total slightly more than $10.6 billion, which exceeds current law by more than $7.8 billion.

Bonding of the ERI Liability

The State could "refinance" the ERI liability by borrowing approximately $1.9 billion at a rate of interest lower than 8.5% and contributing the borrowed money to SERS. The annual debt service on the bonds would then depend on the maturity of the bonds and the interest rate on those bonds.

Over the 10-year period, total ERI payments would be lower when compared to total contributions required by current law. Using a bond interest rate of 5.5%, ERI payments would total $2.456 billion over the 10-year period. If the bond interest rate were 6.0%, total ERI payments would total $2.5 billion. Both of these total contribution amounts may be compared to the $2,805 billion required by current law.

Commission Recommendation

At the January 10, 2005 meeting of the Commission on Government Forecasting and Accountability, the Commission voted 11-0 to recommend to the General Assembly that the ERI liability be refinanced by selling bonds in the amount of slightly more than $1.9 billion. The recommendation is subject to the following conditions:

The bonds must carry a 10-year maturity and repayment must be level principal. Based on the State's experience after the 1991 SERS ERI, it is expected that it will take up to 10 years for State employee headcount to get back up to pre-ERI levels. The 10-year maturity of the bonds would match the expected period the State will realize payroll savings due to the lower headcount. The level principal repayment method is per current law.

All of the bond proceeds (less bond expenses) must be contributed to SERS. To minimize risk, all of the bond proceeds, less reasonable expenses, should be contributed to SERS so the funds may be invested immediately. The last bond issuance used to fund the retirement systems "cashed out" the present value of the expected arbitrage immediately upon issuance of the bonds. The arbitrage value was the result of the significant difference in the interest rate of the bonds (approximately 5%) and the investment return expected to be provided by the investment of the proceeds (8.5%).

The Commission specifically recommends there should be no acceleration of the realization of the value created by the arbitrage. The savings from borrowing at the lower interest rate should be realized annually in the form of lower ERI payments.

The bonds should be sold only if economic conditions are favorable. The Commission recommends issuing the bonds only if the economic and interest rate climate allow the State to realize savings over the 10-year bonding period.

The State should adhere to the current ERI funding law if the bonding recommendation is not followed. The Commission recommends adhering to the current statutory ERI funding provisions if the State is unable to bond for the ERI

liability. Adhering to the current funding provisions assures amortization of the ERI liability over 10 years, rather than shifting some of the costs of the ERI further out into the funding plan.

An Overview of the 2002 SERS Early Retirement Incentive Program

Public Act 92-0566 (HB 2671) created the 2002 SERS ERI and required SERS (and TRS) to determine the net increase in accrued liability resulting from the ERI and report the amount to the Governor and the Pension Laws Commission (now part of the Commission on Government Forecasting and Accountability) by November 15, 2003. In FY 2004, the State was required to contribute $70 million to SERS ($1 million to TRS) towards this liability, and in FY 2005 through FY 2013, to amortize, at 8.5% interest, the remaining ERI liability, in equal annual installments (as certified by SERS and TRS). In November of 2003, SERS certified an annual contribution of $380.3 million and TRS certified an annual contribution of $1.7 million.

Public Act 93-0839 (SB 2206) amended the State Employees' and Teachers' Articles of the Pension Code to provide the impact of the ERI must be recalculated, based on the increase in the present value of future benefits resulting from the ERI. Generally, changing the definition of the impact of the ERI to the present value of future benefits is a more accurate measure, as the accrued liability calculation includes cost factors that were not really the result of the ERI.

According to SERS, the increase in the present value of future benefits that resulted from the ERI was $1.75 billion, while the increase in accrued liability resulting from the ERI totaled $2.3 billion. The amount of the reduction, $550 million, will be funded over the remainder of the current funding plan (40 years), rather than funded as ERI liability over 10 years.

Public Act 93-0839 also provides that the State will contribute $70 million to SERS for the ERI in FY 2005, and the remainder of the increase in the present value of future benefits will be amortized over 10 years beginning in FY 2006. A level dollar payment is required. On October 19, 2004, SERS certified the annual ERI contribution required beginning in FY 2006 as $280.5 million. This certification recognizes the $1.75 billion in ERI liability that must be funded separately has grown to slightly more than $1.9 billion due to contributions of only $70 million in FY 2004 and FY 2005. This contribution amount was not sufficient to pay the interest, at 8.5% on the $1.75 billion beginning balance, causing the "principal" to grow to more than $1.9 billion.

Public Act 93-0839 required the Commission on Government Forecasting and Accountability to hold one or more hearings to review recommendations related to the funding of the 2002 SERS ERI. The Commission is to file a report with the General Assembly "making its recommendations relating to funding of early retirement incentives under this Section; the Commission's report may contain both majority recommendations and minority recommendations." This report provides the SERS ERI funding alternatives discussed at required meetings of the Commission on Government Forecasting and Accountability.

2002 SERS ERI Funding Options

The are two variables that may be changed regarding the funding of the 2002 SERS ERI liability; the length of the amortization period and the interest rate. The amortization may be changed by rolling the ERI liability back into the regular SERS funding plan, specifying a different amortization period in which the State will make payments to SERS, or selling bonds with different maturities and using the proceeds to "pay off" SERS. The interest rate could be reduced by selling bonds with an interest rate of less than 8.5%.

This section discusses the four possible ERI funding options and the effect of those options on the required FY 2006 State contributions to SERS. For each option discussed Table 1 provides a summary of the required SERS ERI contributions for the remainder of the funding plan. In addition, Table 2 provides the total required contributions to SERS for each of the ERI funding options.

Current Law

Under current law, the State is required to amortize slightly more than $1.9 billion in liability over 10 years beginning in FY 2006. The statutory interest rate to be used in the calculation of the amortization payments is 8.5%, which is the assumed investment return of SERS. The resulting ERI payment is $280.5 million annually, beginning in FY 2006. This is the only ERI funding option that would not require a legislative change.

Changing the Amortization Period Within SERS

The current ERI funding provision could be changed so the liability is funded over a period of longer than 10 years. Essentially, the State could extend the period in order to reduce the annual cost. The interest rate would remain at 8.5%. If the amortization period were extended to 20 years, the annual ERI payment to SERS would total $202.7 million, or $77.8 million less annually through 2015 than current law. But, as the annual payments under this alternative would continue until FY 2025, total contributions would be about $1.25 billion more than those required by current law.

No Separate ERI Funding

If the ERI liability were rolled back into the current regular SERS funding plan, the ERI liability would be funded over the remainder of the current fund plan (40 years) like the rest of the SERS unfunded liabilities. According to SERS, the required FY 2006 ERI contribution would be only $21.5 million if it were funded over 40 years, or $259 million less than required by current law. In fact, the contributions to SERS for the ERI would be very low for the first several years after the change was made. Then, as the end of the funding plan approaches, the required ERI contributions to SERS become significantly greater than if funded according to current law. Under this scenario, ERI contributions over the remainder of the funding plan would total slightly more than $10.6 billion, which exceeds current law by more than $7.8 billion.

Bonding of the ERI Liability

The State could "refinance" the ERI liability by borrowing approximately $1.9 billion at a rate of interest lower than 8.5% and contributing the borrowed money to SERS. The

annual debt service on the bonds would then depend on the maturity of the bonds and the interest rate on those bonds. The interest rate on the bonds would of course depend on market conditions at the time of the bond sale. Table 1 shows the required annual payments if the bonds carried an interest rate of 5.5% or 6.0%. Per current law, a level principal payment is assumed.

Over the 10-year period, total ERI payments would be lower under either interest rate when compared to total contributions required by current law. Using a bond interest rate of 5.5%, ERI payments would total $2.456 billion over the 10-year period. If the bond interest rate were 6.0%, total ERI payments would total $2.5 billion. Both of these total contribution amounts may be compared to the $2.805 billion required by current law.

Bonding the ERI liability does involve a certain level of risk. If the proceeds of the bonds are contributed to SERS and invested with the other system assets, there is a chance that the investment return provided to SERS may be less than the interest paid on the bonds. In addition, the State would lose the flexibility to reduce the ERI contributions to SERS in the future. Debt service payments would have to be made regardless of the financial condition of the State.

Table 1

State Employees' Retirement Systems
Required ERI Contributions
(millions of $)

FY	Current Law	20 Year Funding	No Separate ERI Funding	Bonding 5.5%	Bonding 6.0%
2006	$280.5	$ 202.7	$ 21.5	$284.0	$293.0
2007	280.5	202.7	44.8	283.0	291.0
2008	280.5	202.7	69.7	273.0	280.0
2009	280.5	202.7	97.2	262.0	268.0
2010	280.5	202.7	127.2	252.0	257.0
2011	280.5	202.7	133.0	241.0	246.0
2012	280.5	202.7	138.9	231.0	234.0
2013	280.5	202.7	145.0	220.0	223.0
2014	280.5	202.7	151.4	210.0	212.0
2015	280.5	202.7	158.1	200.0	200.0
2016	0.0	202.7	165.1	0.0	0.0
2017	0.0	202.7	172.3	0.0	0.0
2018	0.0	202.7	180.0	0.0	0.0
2019	0.0	202.7	188.1	0.0	0.0
2020	0.0	202.7	196.6	0.0	0.0
2021	0.0	202.7	205.5	0.0	0.0
2022	0.0	202.7	214.9	0.0	0.0
2023	0.0	202.7	225.0	0.0	0.0
2024	0.0	202.7	233.5	0.0	0.0
2025	0.0	202.7	242.5	0.0	0.0
2026	0.0	0.0	251.3	0.0	0.0
2027	0.0	0.0	261.0	0.0	0.0
2028	0.0	0.0	271.3	0.0	0.0
2029	0.0	0.0	282.0	0.0	0.0
2030	0.0	0.0	293.3	0.0	0.0
2031	0.0	0.0	305.1	0.0	0.0
2032	0.0	0.0	317.6	0.0	0.0
2033	0.0	0.0	330.4	0.0	0.0
2034	0.0	0.0	344.0	0.0	0.0
2035	0.0	0.0	358.1	0.0	0.0
2036	0.0	0.0	372.8	0.0	0.0
2037	0.0	0.0	388.1	0.0	0.0
2038	0.0	0.0	404.0	0.0	0.0
2039	0.0	0.0	420.5	0.0	0.0
2040	0.0	0.0	437.6	0.0	0.0
2041	0.0	0.0	455.2	0.0	0.0
2042	0.0	0.0	473.5	0.0	0.0
2043	0.0	0.0	492.5	0.0	0.0
2044	0.0	0.0	512.2	0.0	0.0
2045	0.0	0.0	533.5	0.0	0.0
Total	**$2,805.0**	**$4,054.0**	**$10,614.3**	**$2,456.0**	**$2,504.0**
Difference	$ 0.0	$1,249.0	$7,809.3	($349.0)	($301.0)

Table 2 provides projections of the total required annual State contributions to SERS based on the discussed ERI funding alternatives and annual ERI contribution amounts shown in Table 1.

Table 2

State Employees' Retirement Systems
Total Required Contributions
(millions of $)

FY	Current Law	20 Year Funding	No Separate Funding	Bonding Total ERI	
				5.5%	6.0%
2006	$ 690.2	$ 612.4	$ 431.2	$ 693.7	$ 702.7
2007	762.9	685.1	527.1	765.4	773.4
2008	830.6	752.8	619.8	823.1	830.1
2009	919.2	841.4	735.9	900.7	906.7
2010	1,013.9	936.1	860.6	985.4	990.4
2011	1,052.2	974.4	904.7	1,012.7	1,017.7
2012	1,082.0	1,004.2	940.4	1,032.5	1,035.5
2013	1,123.1	1,045.3	987.6	1,062.6	1,065.6
2014	1,162.6	1,084.8	1,033.5	1,092.1	1,094.1
2015	1,201.4	1,123.6	1,079.0	1,120.9	1,120.9
2016	961.5	1,164.2	1,126.6	961.5	961.5
2017	1,003.9	1,206.6	1,176.2	1,003.9	1,003.9
2018	1,048.5	1,251.2	1,228.5	1,048.5	1,048.5
2019	1,095.6	1,298.3	1,283.7	1,095.6	1,095.6
2020	1,145.2	1,347.9	1,341.8	1,145.2	1,145.2
2021	1,197.4	1,400.1	1,402.9	1,197.4	1,197.4
2022	1,252.4	1,455.1	1,467.3	1,252.4	1,252.4
2023	1,310.6	1,513.3	1,535.6	1,310.6	1,310.6
2024	1,360.5	1,563.2	1,594.0	1,360.5	1,360.5
2025	1,412.7	1,615.4	1,655.2	1,412.7	1,412.7
2026	1,464.3	1,464.3	1,715.6	1,464.3	1,464.3
2027	1,520.8	1.520.8	1,781.8	1,520.8	1,520.8
2028	1,580.4	1,580.4	1,851.7	1,580.4	1,580.4
2029	1,643.1	1,643.1	1,925.1	1,643.1	1,643.1
2030	1,708.8	1,708.8	2,002.1	1,708.8	1,708.8
2031	1,777.6	1,777.6	2,082.7	1,777.6	1,777.6
2032	1,849.8	1,849.8	2,167.4	1,849.8	1,849.8
2033	1,925.1	1,925.1	2,255.5	1,925.1	1,925.1
2034	2,003.9	2,003.9	2,347.9	2,003.9	2,003.9
2035	2,086.4	2,086.4	2,444.5	2,086.4	2,086.4
2036	2,172.1	2,172.1	2,544.9	2,172.1	2,172.1
2037	2,261.2	2,261.2	2,649.3	2,261.2	2,261.2
2038	2,353.7	2,353.7	2,757.7	2,353.1	2,353.1
2039	2,449.7	2,449.7	2,870.2	2,449.7	2,449.7
2040	2,549.1	2,549.1	2,986.7	2,549.1	2,549.1
2041	2,652.2	2,652.2	3,107.4	2,652.2	2,652.2
2042	2,758.9	2,758.9	3,232.4	2,758.9	2,758.9
2043	2,869.4	2,869.4	3,361.9	2,869.4	2,869.4
2044	2,984.0	2,984.0	3,496.2	2,984.0	2,984.0
2045	3,102.9	3,102.9	3,635.5	3,102.9	3,102.9
Total	**$65,339.2**	**$66,588.8**	**$73,148.5**	**$ 64,990.2**	**$65,038.2**

Commission Recommendation

At the January 10, 2005 meeting of the Commission on Government Forecasting and Accountability, the Commission voted 11-0 to recommend to the General Assembly that the ERI liability be refinanced by selling bonds in the amount of slightly more than $1.9 billion. The recommendation is subject to the following conditions:

> ***The bonds must carry a 10-year maturity and repayment must be level principal.*** Based on the State's experience after the 1991 SERS ERI, it is expected that it will take up to 10 years for State employee headcount to get back up to pre-ERI levels. The 10-year maturity of the bonds would match the expected period the State will realize payroll savings due to the lower headcount. The level principal repayment method is per current law.
>
> ***All of the bond proceeds (less bond expenses) must be contributed to SERS.*** To minimize risk, all of the bond proceeds, less reasonable expenses, should be contributed to SERS so the funds may be invested immediately. The last bond issuance used to fund the retirement systems "cashed out" the present value of the expected arbitrage immediately upon issuance of the bonds. The arbitrage value was the result of the significant difference in the interest rate of the bonds (approximately 5%) and the investment return expected to be provided by the investment of the proceeds (8.5%).
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> The Commission specifically recommends there should be no acceleration of the realization of the value created by the arbitrage. The savings of borrowing at the lower interest rate should be realized annually in the form of lower ERI payments.
>
> ***The bonds should be sold only if economic conditions are favorable.*** The Commission recommends issuing the bonds only if the economic and interest rate climate allow the State to realize savings over the 10-year bonding period.
>
> ***The State should adhere to the current ERI funding law if the bonding recommendation is not followed.*** The Commission recommends adhering to the current statutory ERI funding provisions if the State is unable to bond for the ERI liability. Adhering to the current funding provisions assures amortization of the ERI liability over 10 years, rather than shifting some of the costs of the ERI further out into the funding plan.

BACKGROUND

The Commission on Government Forecasting and Accountability, a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;
2) Analysis of the fiscal impact of revenue bills;
3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;
4) Periodic assessment of capital facility plans;
5) Annual estimates of public pension funding requirements and preparation of pension impact notes;
6) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services;
7) Administration of the State Facility Closure Act.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes several reports each year. In addition to a Monthly Briefing, the Commission publishes the "Revenue Estimate and Economic Outlook" which describes and projects economic conditions and their impact on State revenues. The "Illinois Bond Watcher" report examines the State's debt position as well as other issues directly related to conditions in the financial markets. The "Financial Conditions of the Illinois Public Retirement Systems" provides an overview of the funding condition of the State's retirement systems. Also published are an Annual Fiscal Year Budget Summary; Report on the Liabilities of the State Employees' Group Insurance Program; and Report of the Cost and Savings of the State Employees' Early Retirement Incentive Program. The Commission also publishes each year special topic reports that have or could have an impact on the economic well being of Illinois. All reports are available on the Commission's website.

These reports are available from:

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