COMMISSION ON GOVERNMENT FORECASTING AND ACCOUNTABILITY

PENSION IMPACT NOTE

102ND GENERAL ASSEMBLY

BILL NO: **SB 3624** January 31, 2022

SPONSOR (S): DeWitte

SYSTEM(S): Downstate Police, Downstate Fire

FISCAL IMPACT: Please see Appendix I on the following page. The appendix contains a commentary from the Commission's actuary, Segal Consulting, on "best practices" for pension funding. Segal also provides a general assessment on the advisability and impact of lowering the funding target from 90% to 80% for Downstate Police and Fire pension funds.

<u>SUBJECT MATTER</u>: SB 3624 amends the Downstate Police and Downstate Fire articles of the Pension Code. The bill lowers the long-term statutory funding target from 90% funded by 2040 to 80% funded by 2040.

<u>COMMENT:</u> Pension funds established under Articles 3 and 4 of the Pension Code are commonly referred to as “Downstate” police and fire pension funds. These funds cover municipal police and fire personnel in all municipalities except for Chicago and those municipalities under 5,000 in population. P.A. 96-1495, which took effect on January 1, 2011, put in place a new funding policy for municipalities under which Downstate police and fire pension funds must attain a 90% funding ratio by municipal year 2040. The annual employer contribution amount to be made by the pertinent employer is determined by an actuary employed by the Illinois Department of Insurance, although the law allows either the pension fund or the employer to hire their own actuary to make the annual contribution determination.

SB 3624 amends the Downstate Police and Fire articles of the Pension Code to lower the long-term funding target for these funds, such that instead of funding to attain a 90% funding ratio by 2040, the new long-term funding target would be set at 80% by 2040.

Appendix I

Statement from Segal Consulting

Senate Bill 3624 (SB 3624) proposes to lower the target funded percentage in 2040 for Downstate Police and Firefighter plans (plans covered by Article 3 and Article 4 of the Illinois Pension Code) from 90% to 80%. Model practice according to a Conference of Consulting Actuaries (CCA) white paper on public sector pension funding requires a 100% funding target. General Policy Objective #1 from the white paper states: "The principal goal of a funding policy is that future contributions and current plan assets should be sufficient to provide for *all benefits* [emphasis added] expected to be paid to members and their beneficiaries when due." The current 90% target results in a method that is outside the parameters for model practice according to the CCA white paper and fails General Policy Objective #1. Lowering the target funded percentage to 80% would move even further away from model practice.

Note that the funded percentage metric is calculated using an actuarial accrued liability and does not reflect the full projected value of all benefits expected to be paid to members and beneficiaries as of a valuation date. Reaching 100% funding simply indicates being "on track" for meeting long-term funding goals, it does not indicate an absence of ongoing costs. Ongoing costs of a pension plan are identified through what is known as the annual "normal cost", where deficiencies created by actuarial losses (i.e., unfunded actuarial accrued liability) are allowed to be amortized, but should be paid in full. With public sector pension plans that are under 100% funded, contributions should be structured to reach 100% within a reasonable period of time.

The Actuarial Standards Board recently approved an updated version of Actuarial Standard of Practice (ASOP) #4 "Measuring Pension Obligations and Determining Pension Plan Costs or Contributions." That ASOP discusses calculating and disclosing a "reasonable" actuarially determined contribution for most plans. Within that discussion it states that "when selecting an amortization method, the actuary should select an amortization method that is expected to produce total amortization payments that are expected to fully amortize the unfunded actuarial accrued liability within a reasonable time period or reduce the unfunded actuarial accrued liability by a reasonable amount within a sufficiently short period." Put simply, the amortization should either effectively target 100% funding, or entail minimal to no negative amortization (contributions that do not cover interest on the unfunded liability, causing it to compound and grow). SB 3624 would do neither – it would not target 100% funding and would entail significant amounts of negative amortization. SB 3624 would not produce "reasonable" actuarially determined contribution according to actuarial standards.

The primary reason to avoid extended periods of negative amortization is that unfunded liability (and by extension, systematic maintenance of unfunded liability by statute) is

expensive and increases long-term costs of the pension program. These costs compound and grow the longer effective contributions are deferred, as illustrated by plans in Illinois. The only way (without benefit adjustments) to reduce costs effectively for pension plans burdened with high unfunded liabilities is to proactively work to pay down and eliminate those unfunded liabilities. Additionally, a pension system that targets and reaches 100% funding will have increased flexibility relative to investment strategy, reducing investment risk, and even general risk management compared to a system that targets an 80% or 90% funding level.

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