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Pension Spotlight: Illinois

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Sector **U.S. Public Finance, Pensions, U.S. States**

Tags **Americas**

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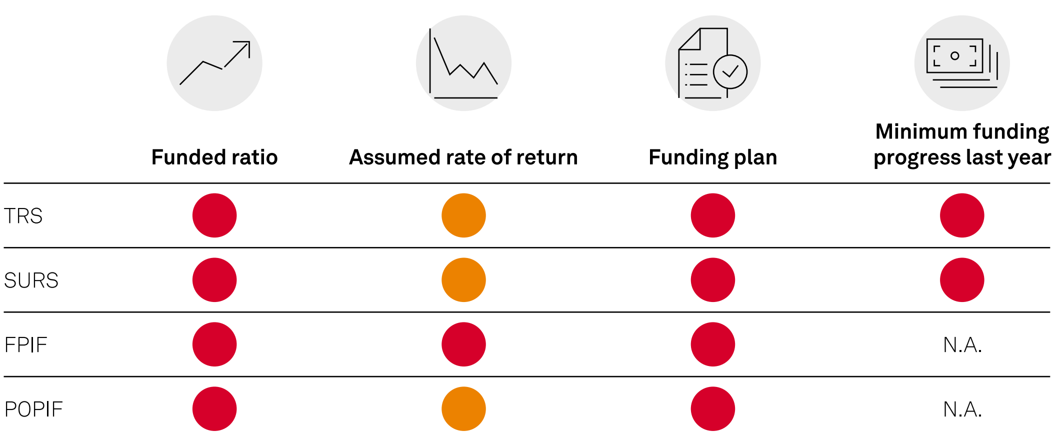
Key Takeaways

- We believe pensions have an elevated probability of stressing the state and local governments' budgets even as Illinois has made supplemental contributions above the statutorily required amounts.
- Costs will keep rising because contributions are significantly short of meaningful funding progress, plans are poorly funded, and the Illinois Pension Code allows plans to use assumptions and methodologies that defer costs.
- The enactment of a new benefit tier in 2010 is generating significant cost savings today but recent efforts have been made to increase these benefits in an attempt to avoid violating social security's safe harbor provision.
- Retiree health care benefits are constitutionally protected in the state but remain unfunded. We expect costs will escalate, in part due to medical inflation.

Pension overview: Illinois



FPIF--Firefighters' Pension Investment Fund. N.A.--Not available for agent plans. POPIF--Police Officers' Pension Investment Fund. SURS--State Universities Retirement System. TRS--Teachers' Retirement System.
Source: S&P Global Ratings.

Credit Fundamentals By Sector

State of Illinois: Pension costs will keep rising, as Illinois has adhered to policies that defer contributions and weigh down its pension plans' funded status. Even with efforts to reduce costs, buy out liabilities, and recently, contribute more than what was statutorily required, fixed pension costs related to the five state-sponsored plans (see Overview section) are projected to increase at an annual average rate of more than 2.2% over the next 10 years, according to the Commission of Government Forecasting and Accountability's Special Pension Briefing, published November 2022.

Local governments: Most municipalities sponsor single-employer public safety plans, very few of which are adequately funded. We expect cities, towns, and villages with poorly funded single-employer pension plans, elevated property taxes, and weak demographic trends will face budgetary pressure from rising pension obligations. The consolidation of the single-employer downstate and suburban public safety plans into a multiple-employer agent plan will provide some administrative cost savings but for many plans, the shift to an asset mix that justifies a discount rate greater than 7% may mean more volatility and potentially higher costs. However, this is not yet guaranteed to proceed, as the Illinois Supreme Court has agreed to hear arguments on the legality of the consolidations. Most local governments also participate in the well-funded Illinois Municipal Retirement Fund (IMRF) agent multiple-employer plan, and we expect the budgetary stress from this plan will be minimal for local governments.

School districts, community colleges, state universities: For school districts and community colleges outside Chicago, and for state universities, the costs associated with the cost-sharing, multiple-employer statewide plans are minimal at this time because the state covers most of them. However, a looming risk is that the state could reduce shared revenue or shift a larger portion of the costs.

Utilities: Most utility system employees participate in the well-funded IMRF agent multiple-employer plan. Pension pressures are minimal in this sector.

Pension Plans Overview

The state sponsors five large, public defined-benefit employee retirement systems.

Single-employer, defined-benefit plans with the state as the employer

- General Assembly Retirement System (GARS)
- Judges' Retirement System (JRS)
- State Employees' Retirement System (SERS)

Cost-sharing, multiple-employer, defined-benefit plans funded by the state as well as local government employers within the state

- State Universities Retirement System (SURS)
- Teachers' Retirement System (TRS)

All of the five state-sponsored plans are poorly funded, and contributions need to increase before meaningful funding progress is made. We have not included GARS, JRS, and SERS in chart 1, chart 3, and the appendix as the costs and liabilities associated with the GARS and JRS plans are small relative to those of the other state plans, and SERS is a single-employer plan covered in our **analysis** on the State of Illinois published Feb. 23, 2023, on RatingsDirect.

While SURS and TRS are cost-sharing plans, the state makes most of the contributions on behalf of the participating entities as a nonemployer contributing entity, covering costs for school districts and state universities. Although costs are currently low for these contributing entities, we expect they will become a larger percentage of the budget for issuers with limited budgetary growth. In addition, in the past legislators have discussed shifting a portion of the costs associated with SURS and TRS, but such a shift never advanced into law. This change, if ever implemented, would result in varying degrees of budgetary pressure for the participating entities. While such a shift may be considered politically difficult, it is possible and, therefore, credit risk to local governments remains. Even if these costs are not directly shifted, negative impacts could be felt indirectly due to redistribution of state-shared revenue to the state pension plans, which could create stress for local governments' budgets.

Plans not sponsored by the state

Chicago Public School teachers participate in the Public School Teachers' Pension and Retirement Fund of Chicago, as opposed to the statewide TRS plan. A law signed in 2017 includes a clause that Illinois will contribute the employer normal cost to the Public School Teachers' Pension and Retirement Fund of Chicago with these appropriated funds. Under this law, more of the state's budget is devoted to pension costs.

IMRF is an agent multiple-employer plan that is not funded by the state and is managed by an independent board. It administers pension plans for almost 3,000 employers in the state while pooling assets under one investment manager. Although IMRF uses a high, 7.25% assumed return and discount rate and amortizes its liability over 20 years at a level percentage of payroll, we view the plan to be at limited risk of contribution escalation, in part because it is funded near 90% as a whole.

Police and firefighter public safety plans, after years of poor funding (55.8% and 55.7% funded in aggregate, respectively, in fiscal 2020), were consolidated from 650 individual plans into two agent multiple-employer plans: the consolidated Police Officers' Pension Investment Fund (POPIF) and the consolidated Firefighters' Pension Investment Fund (FPIF). The state enacted the consolidations to lower costs through greater economies of scale and to improve investing options for the smaller plans. The consolidated plans will continue using funding requirements set out in the Illinois pension code that are not actuarially recommended. In chart 1, our view of the funding plan for these agent plans reflects the statutory requirements. Our view of the funding plan will vary by issuer, as issuers can fund above the statutory requirements.

All single-employer firefighter plans have transferred their assets to FPIF. For POPIF, 332 of 357 eligible funds have transferred their assets; however, 15 of the remaining funds have been restricted under a circuit court stay order ruling. The appellate court ruled that consolidation is constitutional and that the funds can be released, but this is being presented to the state supreme court.

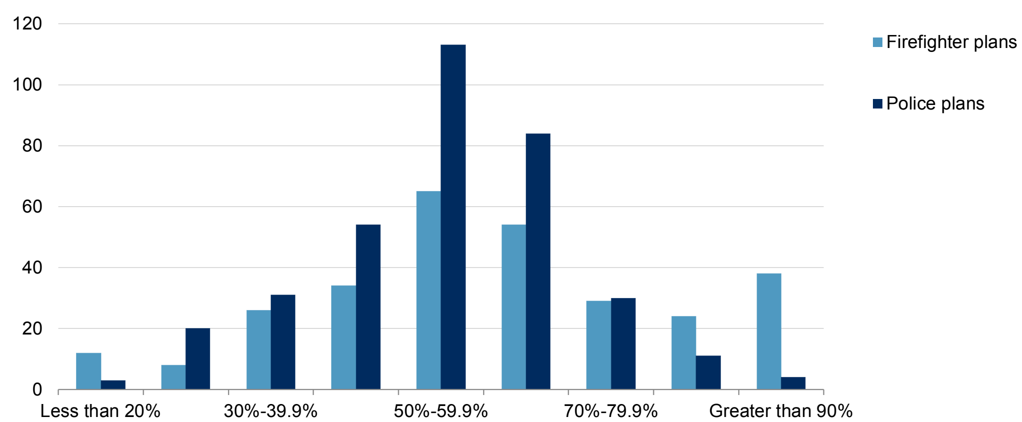
FPIF and POPIF have adopted a 7.125% and 6.8% market return assumption, respectively. We view the market return assumptions for the consolidated plans as indicative of elevated market risk, which could lead to contribution volatility. These assumed returns, and resulting discount rates, will improve reported funded ratios for 56 of the 171 police plans and 38 of the 71 firefighters' plans included in chart 1 in "

Pension Brief: Single-Employer Pension Plans Are Straining Illinois Municipalities' Credit Quality

," published July 27, 2021. As we highlighted there, contribution volatility could be difficult for many municipalities to incorporate into budgets and could therefore pose a risk to credit quality.

Chart 2

Single-Employer Police and Firefighter Funded Ratios

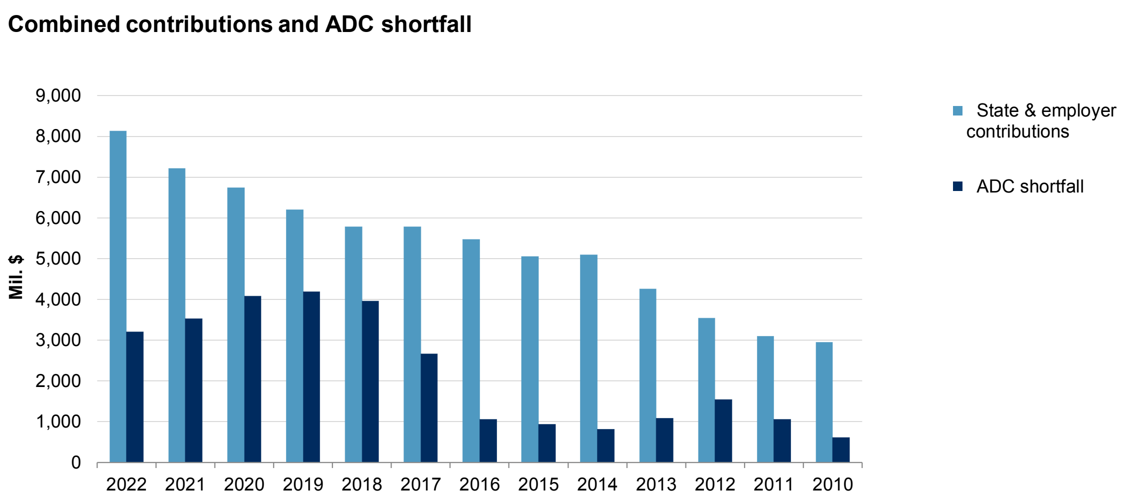


Source: State of Illinois Department of Insurance Public Pension Division 2021 Biennial Report.

Increased Contributions Still Fall Short

In fiscal years 2022 and 2023 (year ending June 30), Illinois contributed to a pension stabilization fund in addition to the statutorily required amounts for the state-sponsored plans; the recently adopted 2024 budget includes another supplemental payment of $200 million to the pension stabilization fund. With the additional payments from the pension stabilization fund, the state will have contributed an additional $700 million to the five state-sponsored plans. However, contributions are still short of an amount we consider indicates funding progress. The escalating contribution schedule laid out in the Illinois pension code, plus the supplemental contributions, has improved the state's actuarially determined contribution shortfall. With these escalating schedules and supplemental payments, we believe contributions will be close to static funding levels in 2023 and 2024, which is the amount needed to sustain the current funded levels should assumptions be met. However, contributions will remain short of actuarial recommendations.

Chart 3



Source: Published annual comprehensive financial reports. ADC--Actuarially determined contribution.

The statutory funding requirements are calculated using assumptions that we believe increase the probability of costs increasing more than expected. Contributions target only a 90% funded ratio, which is not actuarially recommended and results in underfunding. Beyond a funding goal of less than 100%, unfunded liabilities are amortized using a level percentage of payroll with payroll growth that we believe has not been keeping pace with assumptions. According to S&P Global Market Intelligence data, state and local government wages in Illinois increased at annual rates of less than 3.0% in eight of the past 10 years. Wages rose by more than 5% in 2022 due, at least in part, to salary pressure caused by high inflation and labor force shortages. Projections for fiscal 2023 show another year of strong wage growth for state and local government workers in Illinois but, once again, we believe this will be driven by the same factors that we are not certain will persist.

Another form of payment deferral is the use of the projected unit credit cost method (which backloads employee costs toward the end of their careers). Contributions are further deferred by a unique cap that limits the contributions based on a formula built around previously issued pension funding bonds. The Illinois Commission on Government Forecasting and Accountability estimates pension costs will be level as the budget increases over the next 20 years. If plan assumptions or the expected budget growth does not materialize, pension costs could further strain the budget and crowd out other expenditures.

Reductions to benefits are not possible for Illinois pensions and other postemployment benefits (OPEB), as courts have ruled that Article XIII, Section 5, of the state's 1970 constitution, the so-called "pension protection clause," characterizes pension membership as "an enforceable contractual relationship" and declares categorically that pension and OPEB benefits "shall not be diminished or impaired." The state has, however, made several changes to help reduce cost increases. These include the implementation of a benefit reduction buyout program and a limited buyout opportunity program that will be funded with bond proceeds; we expect both will result in marginal budgetary savings for the state. In our view, a more meaningful cost-saving change was the implementation of a second tier of employee benefits (Tier 2). With the enactment of Tier 2 back in 2010, retirement ages were increased, and cost-of-living adjustments were reduced to a simple interest basis with a cap instead of a compounded basis. These changes reduce costs, particularly the normal cost, which is the cost an issuer would pay into a fully funded plan. Table 1 shows the significant normal cost difference between Tier 1 and 2 participants in the year that the number of Tier 2 participants is projected to surpass Tier 1 participants. The significant normal cost savings with Tier 2 have materially helped manage unfunded liabilities and reduce pension costs. However, the total number of Tier 2 retirees is not expected to surpass Tier 1 retirees for 20 years, so it will take time for material cost savings to be realized from the cheaper new benefit tier.

Table 1

Projected normal cost comparisons

Plan	Fiscal year	No. of active Tier 1 particpants	Projected active Tier 1 normal cost ($)	No. of active Tier 2 participants	Projected active Tier 2 normal costs ($)
TRS	2027	76,244	2,039,604,102	82,661	370,055,420
SURS	2023	26,708	563,095,000	32,334	176,325,000

Source: Projections in each plans' actuarial assessement. SURS--State Universities Retirement System. TRS--Teachers' Retirement System.

Under Tier 2, the capped cost-of-living adjustments could result in benefit payments violating social security's safe harbor provision if inflation persists at elevated levels. If the safe harbor provision is violated, employers are required to pay Federal Insurance Contribution Act (FICA) taxes, which would allow employees to participate in social security. Changes were made with the downstate firefighters' consolidation and the state recently passed a bill that raises the pensionable salary cap and benefits for Tier 2 employees in Cook County's pension system to avoid triggering the safe harbor provision. Segal Consulting recently analyzed the impact of changes to pension cost projections to TRS, SURS, and SERS to maintain an exemption from FICA taxes. In this analysis, Illinois' 2022 unfunded liability would increase by $285 million, and the state would need to add a further $5.6 billion to its contributions through 2045. Even with the projected changes, the savings from Tier 2 benefits would still be significant. However, we believe an unexpected increase to pension costs will make annual contributions more challenging to fit into budgets.

Retiree Medical Benefits Are Overshadowed By Pensions But Still Loom

Because of Illinois' aging demographics, shrinking population, and lack of money set aside for OPEB, OPEB costs in the state will escalate. We expect cost volatility and increases, as most state OPEB plans are funded on a pay-as-you-go basis and health care cost trends exceed inflation. The Illinois Supreme Court ruled that retiree health care benefits are covered by the pension protection clause and cannot be impaired or diminished.

Appendix

Table 2

Plan details as of most recent plan comprehensive annual financial report

Metric (mil. $ unless otherwise indicated)	TRS	SURS	S&P Global Ratings' view
As of date	**June 30, 2022**	**June 30, 2022**	
Funded ratio (%)	42.84	43.65	Funded ratios below 50% are considered extremely poor and potentially face spiraling effects due to liquidity risk.

Discount rate (%)	7.00	6.50	A discount rate higher than our 6.0% guideline indicates higher market-driven contribution volatility than what we view as within typical tolerance levels around the country.
Total plan ADC	8,948	2,378	Total contributions to the plan recommended by the actuary.
Total actual contribution	5,987	2,136	Total employee and employer contributions to the plan that were made last year.
Actual contribution as % ADC	67	90	Statutory funding payments have historically not met ADC.
Actual contribution as % minimum funding progress	68	70	Below 100% indicates funding slower than what we view as minimal progress. Due to statutory contributions, we expect this will remain below 100%.
Actual contribution as % SF	91	97	Below 100% indicates negative funding progress. Due to the extra contributions made in 2023 and proposed in the 2024 budget, we believe this may approach 100% for the next few years.
Amortization method			
Funding goal (%)	90	90	Actuarial funding method that targets less than 100% funding results in payments not covering normal costs, interest on the unfunded liability, and principal.
Period	Closed	Closed	A closed funding period ensures the obligor plans to reach funding goal during the amortization period.
Length (years)	23	23	Length greater than 20 years[?] generally correllates to slow funding progress and increased risk of escalation due to adversity.

Basis	Level % of payroll	Level % of payroll	Level % of payroll explicitly defers costs, resulting in slow or even negative near-term funding progress. Escalating future contributions may stress affordability.
Payroll growth assumption (%)	3.75	3.00	The higher this is, the more contribution deferrals are incorporated in the level percent funding methodology. There is risk not only of market or other adversity causing unforeseen escalations to contributions, but also of hiring practices not keeping up with assumed payroll growth, leading to contribution shortfalls.
Actuarial cost method	PUC	PUC	PUC methodology defers costs to a participant's later years of service more than the typical entry-age normal methodology.
Longevity	Generational	Generational	A generational assumption reduces risks of contribution “jumps” due to periodic updates from experience studies.

ADC--Actuarially determined contribution. PUC--Projected unit cost. SF--Static funding. SURS--State Universities Retirement System. TRS--Teachers' Retirement System.

This report does not constitute a rating action.

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