

# Illinois Public Pensions

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## Illinois Public Pensions

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## **A fresh look at fixed income Rediscovering the benefits of diversified bond portfolios**

**By Bill Montague, Smith Barney Consulting Group  
Senior Financial Writer**

Bonds and other fixed-income securities have an important role to play in most portfolios. And yet, many investors devote far less attention to their fixed-income holdings than to the equity assets in their portfolios.

In part, this may reflect a common impression that bond investing is a straightforward task compared to the difficult judgments required to select and manage a diversified stock portfolio. Or, perhaps the potential gains—in the form of higher returns or lower risk—don't seem high enough to justify the effort.

In either case, these perceptions are misguided. Modern bond investing is a complex undertaking, but it also offers many attractive opportunities—both in terms of the range of fixed-income assets available to investors, and the available techniques for managing those assets prudently and effectively.

Many investors don't have the time, or the inclination to master the more technical aspects of managing a diversified bond portfolio. They may also find some fixed-income strategies are difficult or impossible to pursue on their own—unless their portfolios are valued in the tens or even hundreds of millions of dollars.

That's why many investors particularly individual investors, may benefit from professional management of their fixed-income holdings. Some potential advantages:

**Greater diversification.** Professional management may

allow investors to gain access to a wider range of fixed-income asset classes and strategies.

**Improved performance.** Skilled asset managers may be able to take advantage of shorter term market trends or use sophisticated risk-control techniques to reduce portfolio volatility.

### **The return of diversification**

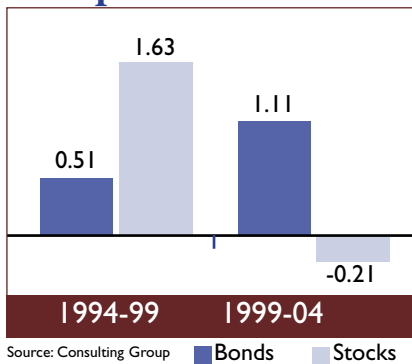
Investment advisors and large institutional investors have long understood the merits of investing at least a portion of their assets in bonds and other fixed-income securities. For other investors, the past few years have been a vivid reminder.

Historically, returns on diversified bond portfolios have tended to be less volatile—and thus less risky—than on stocks and other asset classes that offer no guarantees of income or repayment. By the same token, however, bonds also have tended to pay lower returns.

During the 1990s boom, this tradeoff—lower return for lower risk—wasn't attractive to many investors—not when the stock market appeared to be rising almost effortlessly. Over the five years ending in 1999, the S&P 500 Index generated an annualized return of 28.6%, while the Lehman Government/Credit Index—a proxy for the U.S. bond market—returned just 7.6%. Meanwhile, volatility for the S&P 500 was far below the longer-run trend. Result: On a risk-adjusted basis—that is, even taking into account the higher volatility of equities—the stock market outperformed the bond market by a huge margin. As a result, many investors shifted their portfolios heavily toward equities.

Since then, however, bonds have had a chance to show their worth. Over the five years ending September 2004, the Lehman Government/Credit Index returned an

## Sharpe Ratios



*One way to evaluate different investment assets is to look at their risk-adjusted performance—that is, to compare the returns investors could have earned with the risks they would have faced. A common yardstick for such comparisons is the Sharpe Ratio—a statistical tool developed by William Sharpe, one of the pioneers of modern financial analysis. Sharpe’s formula takes the return on an asset over and above a risk-free benchmark, like the 90-day Treasury bill, and divides it by the standard deviation of those returns. Standard deviation is a common measurement of volatility.*

*The resulting number shows how well investors were compensated for the risks they took. The higher the number, the better the risk adjusted performance. As shown above, stocks (measured by the S&P 500 Index) performed quite well in the late 1990s, but have delivered inferior performance since then compared to bonds (as measured by the Lehman Brothers Government Credit Index).*

annualized 7.74%, while the S&P 500 lost an annualized 1.31%. Meanwhile, stock-market volatility rose significantly. As a result, the performance advantage shifted to bonds. Of course, it’s impossible to say whether this edge will last. Over the past 75 years stocks have tended to pay higher risk-adjusted returns than bonds, although this premium hasn’t been as large historically as it was during the bull market of the late 1990s.

The sources of this performance edge aren’t clear, and financial experts disagree whether it will be as large in the future as in the past. Some argue the equity advantage was largely eliminated by the rise in stock prices during the 1990s—a surge generated, at least in part, by a realization among investors that stocks were undervalued on a risk adjusted basis. If that’s true, future equity returns may be less attractive compared to bonds.

## The investment challenge

Fixed-income asset management, however, is a highly specialized skill, requiring detailed knowledge of the various market sectors, such as Treasuries, agencies, municipals, corporate bonds, and mortgage-backed securities. Bond investors need to understand the market forces that influence those instruments, be able to identify potential risks, and decide how much risk they’re willing to accept in pursuit of higher returns.

These are tall orders for many investors, who lack the time or the technical background to master such tasks. Many have found they’re better off establishing a broad investment strategy, then letting a professional fixed-income asset manager handle the specific buy and sell decisions for their portfolio.

But some investors take the opposite course: They avoid complex market sectors and strategies entirely, and limit their bond investments to a narrow range of securities. Some investors, for example, construct simple “lad-

dered” portfolios of U.S. Treasury securities spread equally across the maturity spectrum, from short-term Treasury bills to longer-term Treasury notes.

This approach does have some advantages. It’s simple and requires relatively little understanding of the fixed-income markets. Treasuries also can be bought directly from the U.S. Government, allowing investors of modest means to build their own portfolios. This can hold down costs such as commissions and fees. And since Treasuries are backed by the full faith and credit of the U.S. Government, they carry no risk of default.

However, the disadvantages may outweigh the benefits. For one thing, Treasuries are not immune to risk. Changes in short-term interest rates or in inflation can have powerful effects on Treasuries—just as they do on other fixed-income assets.

Limiting a portfolio to U.S. Treasuries or other government obligations also ignores the higher returns that may be available elsewhere in the fixed-income universe. Because they are free of default risk, Treasury yields are generally lower than for comparable private-sector securities. Yields on investment-grade municipal bonds are usually lower still—although the interest payments typically are exempt from federal tax. An all-Treasury or all-municipal portfolio may not provide the returns investors need to meet their goals.

### **The benefits of diversification**

On the other hand, given the complexities and costs, it’s reasonable to ask whether the potential gains from a diversified bond portfolio are worth the trouble. The answer is uncertain, since future risk and returns are unknown. However, it is possible to look at the historical record to see whether diversified portfolios have tended to outperform more basic strategies.

To find out, Consulting Group compared the returns on a simple basket of Treasury securities with a hypothetical diversified bond portfolio—one that includes investment grade corporate bonds, high-yield bonds, mortgage-backed securities and international bonds.

Returns for the diversified portfolio were derived from standard indices for the different market sectors. These were given the following weights: 30% Lehman Brothers Intermediate Government/Corporate Index; 10% Lehman Long Government/Corporate Index; 20% Citigroup Mortgage Index; 20% Citigroup High Yield Index; 20% Lehman Non-U.S. World Index.

Because of the difficulty of tracking the performance of individual securities, returns for the Treasury portfolio were also simulated using benchmarks—with a 25% weight for the Lehman 1-3 Year Government Index, 30% for the Lehman Intermediate Government Index and 45% for the Lehman Government indices.

Both examples assume that the portfolios were rebalanced to their target allocations monthly.

The results confirm the value of fixed-income diversification. Over the ten-year period ending September 2004, a diversified portfolio could have delivered higher returns than the all-Treasury strategy, with only a modest increase in portfolio risk. This relative performance advantage has been even more pronounced in recent years. Specifically:

- From September 1994 through September 2004, the diversified bond portfolio could have posted a 7.57% annualized return, versus 6.71% for the laddered Treasury portfolio.
- During that same period, the standard deviation of

returns— a common measurement of risk—could have been 3.94% for the diversified portfolio, only moderately higher than the 3.51% for the laddered Treasury portfolio.

- Over the three-year period ending September 2004, the diversified portfolio could have returned an annualized 8.75%, more than four percentage points higher than the 4.48% return on the all-Treasury portfolio, while its standard deviation could have been 3.91%, roughly equal to the 3.84% standard deviation on the all-Treasury portfolio.

These results don't reflect the management fees or other costs that might have been necessary to pursue a diversified bond strategy. However, they also don't include the benefits—such as lower risk or higher returns—that skilled fixed-income managers might have been able to obtain for their clients.

## Conclusions

Fixed-income assets have an important role to play in most investment strategies. This role could become even more important if stock-market returns in coming years are lower than the outsized returns seen during the 1990s. Effective diversification is a key part of this role.

A diversified strategy should consider the full spectrum of fixed income sectors. However, the optimal mix depends on the specific circumstances of each investor, including their return goals, risk tolerance and, in some cases, their tax situation. Competent professional asset management can help investors reap the benefits of fixed-income investing, while addressing the risks in a prudent, comprehensive manner.

*Reprinted from the Consulting Group newsletter, Smith Barney citigroup.*

## Fixed income risks

All fixed-income investments carry risk—even though for some, like short-term Treasury bills, the risks are so small as to be considered almost negligible. As a rule, the greater the reward, the greater the risk.

Diversification may reduce this risk, but it can't be eliminated entirely. Some of these risks are:

- **Interest rate risk.** When rates rise, prices of existing securities may fall, because the income stream they are expected to pay is no longer as valuable relative to newly issued securities.
- **Inflation risk.** Inflation tends to erode the real value of fixed-income assets, and can also have negative tax consequences, since investors must pay tax on the full amount of interest payments, such as real estate, including the part required to keep up with inflation.
- **Default risk.** Most fixed-income securities other than Treasuries carry some risk the issuer may fail to pay interest and/or principal in a timely way. Even when securities are backed by collateral, such as real estate, investors may receive only partial repayment.
- **Call risk.** Some bonds include provisions allowing the issuer to redeem securities prior to maturity. This can force investors to reinvest in lower-yielding bonds, depriving them of expected future income.
- **Currency risk.** Many foreign securities are denominated in non-U.S. currencies. This can leave investors exposed to loss if those currencies decline in value against the dollar.

It's important for investors to understand that risks can vary widely from sector to sector. Mortgage-backed securities, for example, may lose value when interest rates fall as well as when they rise. Why? Because falling rates often lead homeowners to refinance outstanding loans. This reduces the stream of interest payments to investors. This can result in steep losses. By working with their financial consultant and an experienced portfolio manager, investors can develop a strategy for managing these and other fixed-income risks.

*Smith Barney citigroup*

## **Are OPEB obligation bonds a viable option to fund liabilities?**

**By Parry Young, Primary Credit Analyst, Standard and Poors**

States, cities, and other municipal entities struggling with ongoing difficulties in the wake of the national recession—including sluggish revenue growth, significant capital and pension funding needs, and rapid increases in certain expense sectors—will soon find themselves facing a new concern in the form of other post-employment benefit (OPEB) liability reporting and funding.

OPEB costs are not new: Employers have historically paid them as part of their current operating expenses. What is new is the requirement to quantify the OPEB liability and determine an annual required contribution to amortize the liability. Funding this liability with long-term debt in the form of OPEB obligation bonds (OPEBOBs) could prove to be an option for some entities in the same manner as pension obligation bonds (POBs) have been used to fund pension liabilities.

OPEBs are defined as retiree costs other than, or more accurately, in addition to, monetary pension benefits. The majority of OPEB costs are derived from the payment of promised benefits such as medical care, prescription drugs, and life insurance, among others. OPEB plans (retiree health care plans, for example) are generally distinct from an employer's pension plan but may be administered by the pension system as a separate fund.

A major cause for concern is how rapidly the primary components of OPEB costs have increased—particularly medical care and prescription drugs. These sustained rates of increase, in many cases at double-digit levels, have resulted in OPEB costs accounting for an increasing share of operating expenses. As the expected rates of increase for these costs are projected into the future, the associated liabilities, already estimated to be large, could grow very fast.

The long-term liability related to OPEB plans is generally

not identified or quantified; this, however, is slated to change in the near future. In June 2004 the GASB released Statement 45, “Accounting and Financial Reporting by Employers for post-employment Benefits Other Than Pensions,” which is effective for reporting periods beginning after Dec. 15, 2006. (For further information, see report titled “*Reporting & Credit Implications of GASB 45 Statement on Other post-employment Benefits*,” published Dec. 1, 2004, on RatingsDirect.) With the implementation of GASB 45, employers will be required to account for OPEB expenses in a similar manner as pension benefits. Under the new statement, the liabilities attributable to OPEBs—and the corresponding annual required contributions—would be actuarially determined.

Identifying and quantifying the OPEB liability will, for many entities, result in the realization of a potentially significant unfunded liability—because in the vast majority of cases assets have not been set aside to fund these future OPEB costs. While it is not certain how large these liabilities will be, it is likely that in many cases they will be sizable. In addition to the historical and projected growth rates of the cost components of OPEBs, the fact that the recipients of these benefits are experiencing increasing longevity will also magnify the total liability. This factor will be particularly true for those entities that have entered into generous, lifetime health care benefit arrangements over the years. It is possible that an employer’s unfunded OPEB liabilities could exceed the level of its unfunded pension liabilities.

Faced with addressing a liability of this magnitude through increasing annual required contributions for OPEBs, municipal entities have a handful of options, some of which may be more fiscally responsible than others.

Assuming inaction is not a viable option, to help balance an OPEB plan employers could:

- ◆ Decrease benefits;
- ◆ Close off the existing benefit level for new employees, creating a new tier with lower benefits (as has been done in some cases with pension benefits);

- ◆ Institute, or increase (perhaps significantly), contributions from current members; or
- ◆ Issue OPEBOBs to fund all or a portion of the existing unfunded liability (similar to pension obligation bonds, or POBs).

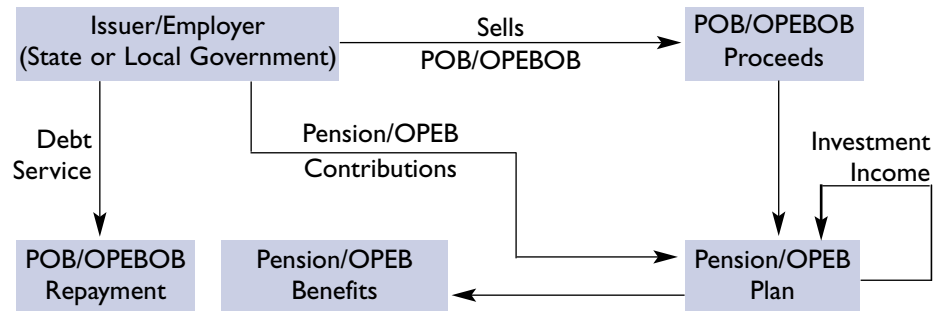
Each of these options presents challenges. In reality, it may not be possible to change an existing plan's benefit structure for a number of reasons, including legal or political ones. Funding the liability with longterm debt (OPEBOBs) could prove to be a viable option for some entities, although this does introduce added risks. According to the 2005 edition of *Governmental Accounting, Auditing, and Financial Reporting*, published by the Government Finance Officers Association, an OPEBOB can be issued to reduce or eliminate the employer's net OPEB obligation to pay an employer's annual required contribution as well as to reduce or eliminate the plan's unfunded actuarial accrued liability.

### **POB and OPEBOB mechanics**

The purpose of POBs is to fund all or a part of a public pension system's unfunded actuarial accrued liability (actuarial liabilities less assets). The POB issuer, as employer or pension sponsor, can provide benefits through its own pension plan or as part of a large state system. POBs are basically arbitrage plays, the success of which depends on the attainment of certain investment return levels by the bond proceeds placed in the pension trust fund over the life of the bonds. The goal is for the issuer's projected carrying charges (debt service cost plus pension contributions) to be lower after the issuance of the POBs than before. For a POB to meet projections, all other things being equal, its proceeds must yield a return of at least the pension fund's investment return assumption, which, on average, is about 8%. If the proceeds earn less, new actuarial losses begin to accrue; if earnings are below the interest cost on the POBs, the transaction acts as a net drain on the issuer's financial resources rather than an enhancement. When OPEB liabilities and annual required contributions are determined for OPEB under GASB 45, using OPEBOBs to fund an OPEB unfunded actuarial accrued liability

could serve the same purpose as POB issuances do for unfunded pension liabilities and function in the same manner.

### Pension and OPEB Obligation Bond mechanics



### OPEBOB issues

As stated above, it is expected that the magnitude of unfunded OPEB liabilities will be quite large, as OPEB liabilities have usually been handled on a pay-as-you-go basis and are therefore almost totally unfunded (no assets have been set aside for this purpose). It is also believed, based on our observations, that there will be significant variation from one government to another because some governments have been generous in handing out health care benefits to retirees, including lifetime benefits, while other have been parsimonious. The unfunded OPEB liabilities for some governments will total in the billions of dollars, while for others the amounts will be small and more manageable.

Calculating actual OPEB liabilities is expected to be very difficult due to the uncertainties in predicting health care costs in the future. For example, it is hard to project what the price of a specific prescription drug will be in 2006, let alone in 2030 when that drug most likely will have been replaced by a more expensive (or possibly cheaper) one. Future changes in retiree health care at the federal level may also affect OPEB liabilities, further complicating projections. In comparison, the determination of pension liabilities is a much more precise (although still not exact) science based on long historic records of employment and salary changes and demo-

graphic trends, among other variables.

It is possible that some government jurisdictions will determine that the promised benefit level related to OPEBs—and the resultant liability burden—is economically unsustainable over the long-term, or that they are unwilling to fulfill these requirements given the scarcity of resources and competing demands. This realization could set the wheels in motion to develop strategies to modulate unfunded OPEB liabilities, including some of the strategies mentioned above, such as the potential use of OPEBOBs.

### **Legal authorization**

Most state and local POBs have primarily been secured by general obligation or general fund pledges—some with voter approval and some without. For example, in California—a state where POBs have been very popular over the past decade—the legal basis for POBs is generally derived from the state’s retirement law, which considers pension liabilities to be an “obligation imposed by law.” It follows that debt (POBs, for example) may be incurred to finance pension unfunded liabilities. Also, most California POB issuers have gone through further validation proceedings in the courts before the bonds were sold. Local government POBs in California are considered appropriation-type debt, in that they are absolute and irrevocable obligations; the security, however, does not include a pledge to increase taxes to pay the bonds.

Using the California example again, OPEB liabilities are not believed to fall into the legal category of an “obligation imposed by law.” However, in most cases OPEB obligations have been established through collective bargaining agreements, and are contractual obligations under the law. As such, there is a basis to assume that the promised benefits will be delivered.

The precise nature of the procedural steps to the funding of OPEB liabilities through the issuance of bonds, therefore, is not entirely clear in that it will be breaking new ground, and the following questions remain:

- ◆ Under what legal authorization would OPEBOBs

be sold?

- ◆ Will existing bond laws permit the issuance of debt to fund such liabilities?
- ◆ Will the precise debt security and structure vary from state to state?

States might have to adopt enabling legislation to permit the sale of OPEBOBs, and laws could very well need to be changed to allow for the establishment of an OPEB trust fund to hold and segregate OPEB assets (including OPEBOB proceeds) to offset these liabilities. Additional legislation may also be required to permit a broad range of investments, including equities, to ensure the likelihood of investment earnings. An OPEB trust fund restricted to fixed income investments, for example, would most likely not be able to post the yields required to make an OPEBOB transaction work economically. Like POBs, OPEBOB proceeds' investment earnings will have to surpass their interest cost to begin to be viable.

Unlike POBs in California, voter approval may be required to authorize bonds to pay OPEB liabilities, which will

make the authorization process all the more complicated and time consuming. However, in other states where POBs issued as general obligations previously received voter approval, there is at least a precedent for the citizen assent to post-retirement benefit liability bond financing. Some employers could also have the option to use appropriation debt to fund OPEB obligations, or a new security might be developed for this purpose.

### **Credit factors**

Standard & Poor's Ratings Services has traditionally viewed pension liabilities as tantamount to long-term debt. These liabilities represent promises made to employees, usually having constitutional or statutory protections. OPEB obligations, while not having the same legal protections as pension obligations, are nonetheless a similar type of liability and also need to be managed effectively so as not to adversely affect an entity's ability to pay debt service on its bonds. Obviously,

the higher the relative funding costs of an entity's OPEB liability the more it can act to constrain an entity's creditworthiness. To the extent that an entity chooses to use bond funding to help manage its OPEB requirements, Standard & Poor's will apply the same type of analysis it applies to POBs. (For further information, see report titled "Pension Obligation Bonds Are Surging After Brief Hiatus," published Jan. 20, 2004, on RatingsDirect.)

*Reprinted from RatingsDirect*

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## **Media takes from around the State**

### **Pensions in need of major overhaul**

*From the Kane County Chronicle*

*By Rachel Beck*

It will cost corporate America plenty to shore up the nation's private pension system. But judging by what happened at United Airlines, it's looking like an expense taxpayers eventually could have to pay.

Just a month ago, the bankrupt airline dumped nearly \$10 billion in pension obligations on the federal government, making it the largest corporate pension default in U.S. history.

Current pension funding rules allowed United to make its retirement plans look as though they were in much better shape, and didn't require the airline to make any cash contributions in recent years, despite its pension

plan's declining health.

From that example alone, it certainly seems like a pension system overhaul is a must.

“We may be approaching a tipping point for defined benefit pension plans,” said David Zion, the accounting analyst at Credit Suisse First Boston. “The accounting rules and funding rules have protected companies from their pension plans for a long time.

“With the use of smoke, mirrors and various smoothing mechanisms, these rules make it appear as if the plans are not volatile, when they really are, and make plans appear healthier than they really are.”

Defined benefit plans, which promise retirees a monthly check and often health coverage, were underfunded by \$354 billion through April of this year, meaning their liabilities far outweighed their assets. That's a 27 percent increase in the shortfall compared with a year ago, according to the Pension Benefit Guaranty Corp., the federal agency that insures pensions.

At UAL Corp.'s United, the carrier is terminating pension programs covering 120,000 active and retired workers to help it emerge from bankruptcy court protection. United's pension funds have \$7 billion in assets, but benefit liabilities total \$16.8 billion. Of that \$9.8 billion difference, the PBGC will cover \$6.6 billion, meaning benefits for United's retirees will be considerably less than if the plans still were active and healthy

But going back, it becomes clear that the situation at United didn't have to turn out this way. According to recent testimony to Congress by Bradley Belt, the PBGC's executive director, the financial health of United and its pension plans had been deteriorating since at least 2000.

As you might expect from a financially distressed business, United put little, if any, cash into the plans—something that was perfectly legal under pension funding rules. Nor did it provide any notice of the severe underfunded condition to its participants.

With cases like that in mind, there is a push in Washington to overhaul the pension system. Among the biggest changes under consideration is to create more stringent funding requirements for calculating how much money companies must contribute to their plans and the schedule to make payments.

There also are proposals to require companies to use the fair market value to measure pension assets, rather than an actuarial estimate that might not be tied to reality, and to tie funding requirements to a company's financial health, based on its credit rating.

Such changes could prove very expensive, doubling or tripling this year's contributions for some companies.

That's the findings of CSFB's Zion, who combed through financial filings for companies in the Standard & Poor's 500 to determine how much possible changes in pension regulation could cost corporate America if they were in effect this year.

He estimates that S & P 500 companies would have to pay \$41 billion to their plans this year if pension reform were fully phased in for 2005. That's about 28 percent higher than the \$32 billion those companies were expecting to contribute.

*Rachel Beck is the national business columnist for The Associated Press. Reprinted with permission of the Kane County Chronicle, June 19, 2005.*

## **Raiding pension funds shows selfishness**

*From the Northwest Herald*

*By Steve Brosinski*

Fee-fi-fo-fum! I see the greedy fingers of government leaders raiding state pension funds.

Be them 'live, or be them dead, they'll grind those retirement bucks to feast on pork.

My apologies to the unknown 17th- or 18th-century author for messing with his or her classic rhyme. But I couldn't resist comparing recent legislative pilfering to

the naughty Englishman's behavior in "Jack and the Beanstalk."

State lawmakers this month voted to prop up a bloated \$54 billion budget by taking \$2.2 billion earmarked for underfunded pension plans.

Gov. Rod Blagojevich rewarded supporters of the spending plan, all Democrats, with \$20 million in pork-barrel projects.

Jane and Joe Blow probably paid more attention to their air condition humming along than the shell game in Springfield. No tax increases, no drastic cuts in human services, and new cash to schools sounds like an undeniably good plan.

While the Blows saw no reason to complain about the legislative money shuffling, their kids will wince when billions of dollars in state IOUs come due.

State government owes \$35 billion to five state-pension plans after years of underpaying these systems. Unlike employees of United Airlines, state pensioners and their families need not worry about losing out because the state constitution obligates full payment on retirement benefits.

Nick Yelverton, Teacher Retirement System director of government affairs, said this latest raid on the educator pension system likely would worsen the state's indebtedness. The budget-balancing act shortchanges state pensions by \$2.2 billion—TRS stands to lose about \$1 billion—over the next two years.

"We had 62 percent funded the last time we did an evaluation," Yelverton said. "This [\$1 billion revenue loss] will bring us down."

In simple terms, TRS had 62 cents in assets for every benefit dollar, but it will shrink to 61 cents or less on the dollar.

Blagojevich has promised \$20 million in special-interest projects to 80 legislator pals. Blagojevich, a scrooge when he pulled the plug on so-called member initiatives early in his administration, now is the candyman.

Incidentally, none of six state legislators representing McHenry County and northern Kane County are on the governor's pork-barrel wish list.

The budgeteers in Springfield apparently thought it was better to pilfer their constituents' beanstalk than do the right thing.

*Steve Brosinski is a Northwest Herald community editor. Reprinted with permission of the Kane County Chronicle, June 17, 2005.*

### **Board divided; widow won't receive pension**

*From the Northwest Herald*

*By Tara Clifton*

Misty Gruenes will not receive the \$48,000-a-year pension for which she has fought for months

The Johnsburg Police Pension Board's split decision Thursday resulted in no pension award.

The four-person board was divided evenly on whether Sgt. William Gruenes of the Johnsburg Police Department, Misty's late husband, was on duty the morning of Jan. 24, 2003, when he died from injuries suffered in a car wreck.

Gruenes, 33, was killed when Lori L. Braun of Hebron ran a stop sign at Thayer and Johnson roads in Hebron and struck his 2002 Chevrolet Impala with her 1989 Ford Tempo, Johnsburg Police Chief Ken Rydberg said.

Because Gruenes had not reached the station, he was off duty at the time, Rydberg said.

Ted Gilbert, Misty's attorney, said William Gruenes was heading from his Harvard home to the McHenry Wal-Mart to have film developed of pictures taken relating to the missing-person case of Brian Carrick. Sgt. Gruenes was completing a work-related task, Gilbert argued, so he was on duty.

Jenette Schwemler, Johnsburg's attorney, countered that driving to Wal-Mart to develop film did not involve a

“special risk,” a dangerous situation related to police work, so he was not on the clock.

Because of the split vote, the village or Misty Gruenes can appeal to the circuit court.

Gruenes, however, is not sure that she wants to continue her fight

“I have to think about how much it costs for a lawyer and if it's worth it,” she said.

The pension battle has been difficult and emotional for Gruenes, a mother of two. While answering questions during Thursday’s hearing, Gruenes’ face reddened and tears spilled down her face. The board took a short break.

For most of the day, Gruenes sat silent and stiff, her head resting on a tightly clenched fist.

She shook her head slightly when Rydberg took the stand.

The pension board, made up of two police officers and two civilians, was supposed to have a retired police officer as a fifth member, but Johnsburg does not have a retired officer, said Richard Reimer, pension board attorney.

The police officers favored giving Gruenes the pension. The two civilians said no.

In a news release issued after the decision, Johnsburg officials said Misty Gruenes had received village compensation totaling more than \$1 million.

“No amount of money can compensate for the loss of a loved one,” Schwemler said, “but at least the Gruenes family has already received compensation to lessen their burden.”

*Reprinted with permission of the Northwest Herald, June 10, 2005.*

## Revised laws affecting retirement plans began March 28

By Bruce Delbecq, CPA, JD, Plante & Moran

Many qualified plans, 403(b) arrangements, and eligible 457(b) plans provide for an involuntary cash out to participants who terminate employment with account balances less than \$5,000. Beginning March 28, 2005, these plans cannot cash out benefits in excess of \$1,000 unless the participant elects to receive a distribution. In the absence of the participant's election, any involuntary distribution between \$1,000 and \$5,000 must be done as an automatic rollover to an IRA.

In reaction to these new provisions, plans are generally either:

1. reducing involuntary distributions to balances of no more than \$1,000;
2. reducing involuntary distributions to balances of no more than \$1,000, and forcing the rollover of balances over \$1,000 and less than \$5,000 to an IRA account; or
3. eliminating involuntary distributions altogether.

Plans must operationally comply with the new automatic rollover provisions (generally invoking one of the three options above) beginning on March 28, 2005, and plan amendments are required by the end of the first plan year after March 28, 2005 (June 30, 2005 for June plan year ends, and December 31, 2005 for calendar plan year ends).

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*Reprinted from the Plante & Moran Not-For-Profit Advisor.*

## Illinois ranks fourth in nation in PBGC benefit payments

Illinois residents last year received more than \$206 million in benefits from the Pension Benefit Guaranty Corporation (PBGC), according to the latest PBGC's Pension Insurance Data Book. The state ranks fourth in the nation in total benefit amount and fifth in the number of recipients.

Almost 29,000 Illinois residents received a pension check from the federal insurer in 2004. The PBGC's single-employer pension insurance program, which assumes the benefit promises of failed company pension plans, paid out about \$3 billion nationwide to 533,000 retirees.

### 2004 PBGC benefit payments by state (top 5)

1.	Pennsylvania	\$514,931,866
2.	.Ohio	\$325,001,140
3.	Florida	\$221,521,125
4.	Illinois	\$206,436,290*
5.	Indiana	\$200,423,088

\* This data does not take into account the recent United Airlines pension woes.

In addition to keeping the promises of failed plans, the PBGC insures almost 1,900 ongoing Illinois-based pension plans, covering 1.8 million individuals.

The PBGC's state-by-state data is one of the many features of the Pension Insurance Data Book, an annually updated statistical reference that tracks the experience of PBGC's insurance programs and the defined benefit pension plans they protect. The Data Book provides researchers, journalists and others interested in the federal pension insurance program with easily accessible, detailed statistics for PBGC's two separate programs covering single-employer and multiemployer plans. For both of PBGC's insurance programs, the book includes

graphs and tables on the financial condition of the program, numbers of people and plans protected by the program, the people receiving or eligible to receive benefits from PBGC and the benefits paid to them, claims against the program, and other vital statistics.

The Data Book is available on PBGC's Web site at [www.pbgc.gov/publications/databook](http://www.pbgc.gov/publications/databook). State-by-state data may also be obtained at [www.pbgc.gov/about/customers/state.htm](http://www.pbgc.gov/about/customers/state.htm).

PBGC is a federal corporation created by the Employee Retirement Income Security Act of 1974 to guarantee payment of basic pension benefits earned by workers. Its two insurance programs cover nearly 44.3 million American workers and retirees participating in more than 31,000 private-sector defined benefit pension plans, including some 1,600 multiemployer plans. The agency receives no funds from general tax revenues. Operations are financed largely by insurance premiums paid by companies that sponsor pension plans and investment returns.

*Pension Benefit Guaranty Corporation*

## **GFOA updates Recommended Practice: Evaluating the Use of Pension Obligation Bonds**

**Background:** An unfunded actuarial accrued liability (UAAL) for pension benefits generally represents the difference between the present value of all benefits estimated to be payable to plan members as a result of their service through the valuation date and the actuarial value of plan assets available to pay those benefits. This amount changes over time as a result of changes in accrued benefits, pay levels, rates of return on investments, changes in actuarial assumptions, and changes in the demographics of the employee base.

State and local governments normally reduce their

unfunded actuarial pension liability over time as part of their annual required pension contribution. Some governments, however, have elected to issue pension obligation bonds to reduce their unfunded actuarial liability as a part of the overall strategy for managing its pension costs. Governments should also realize that, while the UAAL may initially be fully funded, actuarial experience may result in over or under funding over time. Policies should be developed to manage potential over or under funding, regardless of the issuance of POBs.

Pension obligation bonds must be issued on a taxable basis because current federal tax law restricts the investment of the proceeds of tax-exempt bonds in higher-yielding taxable securities. From a purely financial perspective, issuing pension obligation bonds can produce savings for a government if the interest rate paid on the bonds is less than the rate of return earned on proceeds placed in the pension plan. However, governments issuing pension obligation bonds must be aware of the risks involved with these instruments and have the ability to manage these risks.

**Recommendation:** The Government Finance Officers Association recommends that state and local governments use caution when issuing pension obligation bonds. Governments should ensure they are legally authorized to issue these bonds and that other legal or statutory requirements governing the pension fund are not violated. Furthermore, the issuance of the pension obligation bonds should not become a substitute for prudent funding of pension plans.

Governments issuing pension obligation bonds should compare the bond's debt service schedule to the pension system's current UAAL amortization schedule, using the true interest cost of the bond issue as the discount rate to calculate the estimated net present value savings. Additionally, issuing governments should consider the amount of the estimated net present value savings, the spread between the true interest cost of the bonds, and

the actuarial investment return assumption of the pension plan.

Even if the analysis indicates that financial benefits appear to outweigh the risks, governments should evaluate other issues that may arise if the bonds are issued, such as the loss of flexibility in difficult economic times because of the need to make timely payments of principal and interest in order not to default on the bonds, potential misunderstanding by policy makers regarding the possibility that an unfunded liability may reappear in the future, and potential pressures for additional benefits by government employees if plans are fully funded and the government's contribution as a percentage of payroll has declined relative to neighboring jurisdictions.

Before deciding to issue pension obligation bonds, a governmental entity should undertake a careful financial analysis that considers the following:

- Adequate disclosure of the fact that even if bonds are sold, governments could still face an unfunded liability in the future resulting from such factors as changes in benefit levels, investment returns, demographics, or other factors that were not anticipated when the bonds were issued.
- Pension obligation bonds should be structured in a manner that does not defer principal payments. Additionally, the bonds should not have a maturity that is in excess of the current unfunded actuarial accrued liability amortization period.
- Most pension systems have investment practices that are designed to accept smaller incremental contributions than are typical with pension obligation bonds. A review of the system's ability to adequately incorporate a much larger contribution into the system without adversely affecting the system's asset allocation should be considered.
- Issuance of debt to fund pension liability increases debt burden and may use up debt capacity that could

be used for other purposes.

- Issuing pension obligation bonds converts a liability that may not be fully reported on the face of the financial statements (i.e., the unfunded actuarial accrued liability) into a liability that is reported on the face of the financial statements (i.e., bonds payable).
- Governments should ensure that the pension system review its cash flow in order to ensure that benefits are paid in a timely manner, since annual employer contributions will be reduced in lieu of debt service payments on the POBs. Analysis should extend through the amortization period of the unfunded liability on a cash flow basis and the debt service period of the POB.
- Special consideration and analysis should be given to the actuarial and cost implications for individual employers participating in multiple-employer systems.

## References

- *Financing Retirement Systems Benefits*, Richard G. Roeder, Public Employee Retirement Series, GFOA, 1987
- “Pension Obligation Bonds: Practices and Perspectives,” *Government Finance Review*, GFOA, December 1996
- James B. Burnham, *Risky Business? Evaluating the Use of Pension Obligation Bonds*, GFOA, June 2003, pp. 12-17

*Approved by the GFOA Executive Board, March 2005.*

## **Legislative Update: New Laws of Interest (as of June 20, 2005)**

**Number: HB324, Public Act 94-0033**

**Title: BLOOD DONATION**

Description and purpose: Creates the Employee Blood Donation Leave Act. Provides that on request, a participating employee of any unit of local government, board of election commissioners, or any private employer in the State who has 50 or more employees may be entitled to blood donation leave with pay of up to one hour to donate blood every 56 days in accordance with appropriate medical standards.

*Action: Signed by Governor 6/15/2005, Public Act 94-0033*

**Number: HB1633, Public Act 94-0036**

**Title: PERSONAL INFORMATION PROTECTION ACT\***

Description and purpose: Provides that any data collector that owns or uses personal information concerning an Illinois resident shall notify the resident that there has been a breach of the security following discovery or notification of the breach. Provides that any data collector that maintains computerized data that includes personal information that the data collector does not own or license shall notify the owner or licensee of the information of any breach of the security of the data immediately following discovery, if the personal information was, or is reasonably believed to have been, acquired by an unauthorized person. Personal information is considered an individual's first name or initial, last name, and either the individual's social security number, driver's license number, or credit or debit card number in conjunction with any necessary security code. Encrypted personal information is not subject to this act. Effective January 1, 2006.

*Action: Signed by Governor 6/16/2005, Public Act 94-0036*

**The 2005 IGFOA Annual Conference will include a “how-to” guard personal information session on Friday, September 16 to help members comply with this new law. visit [www.igfoa.org](http://www.igfoa.org) for details.**

**Number: SB226, Public Act 94-0028**  
**Title: OPEN MEETING-WEB POSTING**

Description and purpose: Amends the Open Meetings Act. With respect to a public body that has a website maintained by the public body's full-time staff, requires that the public body post on the website (i) notice of any agenda of a regular meeting of the public body's governing body, (ii) notice of all meetings of the governing body, and (iii) beginning July 1, 2006, minutes of regular meetings of the governing body open to the public. Minutes must be posted on the website within 7 days of their approval and remain on the website for 60 days. Provides that failure to post on the website does not invalidate meetings or actions of the governing body.

*Action: Signed by Governor 6/14/2005, Public Act 94-0028*

**Number: SB528, Public Act 94-0029**  
**Title: FIRE/POLICE DEPARTMENT AGE LIMITS**

Description and purpose: Amends the Illinois Municipal Code. Provides that the age limit (Currently 35) applicable to persons seeking municipal employment in either a fire department or police department shall not apply to a person who has served as a sworn officer of the Illinois Department of State Police (this is an addition to a list of several other exemptions).

*Action: Signed by the Governor 6/14/2005, Public Act 94-0029*

*For more information, please visit [http://www.igfoa.org/legislativecomm\\_update.html](http://www.igfoa.org/legislativecomm_update.html).*

## **IGFOA Annual Conference to feature Public Pension sessions**

**September 14-16, 2005 at the Springfield Hilton**

**Details and registration at [www.igfoa.org](http://www.igfoa.org)**

Educational sessions planned for the September 2005 IGFOA Annual Conference include several related to public pensions and post-employment benefits, including:

### **Funding Post Employment Health Care/Lowering Your Unfunded Liability**

VEBA Trusts and Integral Part Trusts have been the programs of choice for establishing post employment health care benefits. Recent IRS Rulings and GASB Statement 45 will impact state and local government and the management of these arrangements. Learn what you can do to offer such arrangements or ensure your current arrangement is in compliance with the new rulings.

*Speaker: John Cripe, Compensation Manager, The City of Lincoln and Lancaster County, Nebraska*

### **IRS Audits of 457 Arrangements— How to be prepared for yours**

Discussion will focus on the selection criteria used to determine which §457 plans will be examined particularly since such plans are a non-return unit, i.e., no Form 5500 is filed. There will also be discussions of technical aspects of §457(b) and (f) plans, such as limits on all employee and employer contributions, trust requirements for governmental entities, and final regulations guidance.

*Speaker: Gary M. Kitts, CEBS, Internal Revenue Agent, Employee Plans Specialist, IRS, Tax Exempt and Governmental Entities (TEGE)*

### **Creative uses of 401(a) Defined Contribution Plans for public sector employers**

This session will cover the basics of 401a plan design explaining how to take advantage of your ERISA exemption to create unique benefit and targeted employee benefit programs with significant tax advantages. Session will include actual case studies from governmental employers.

*Speaker: Chris Gruckenberger, Director of Organizational Resources, City of Naperville*

### **IMRF and Social Security Update**

Get up to speed on IMRF and Social Security!

*Speaker: Louis Kosiba, Executive Director, IMRF*

### **Pension Portability**

Decipher the employer's maze of importing or exporting Downstate Police and Firefighter Pension Fund participants.

*Speaker: Scott Brandt, Acting Chief Administrator, Public Pension Division, State of Illinois*

*All sessions and speakers are subject to change. Refer to [www.igfoa.org](http://www.igfoa.org) and the final program for confirmed details.*

## **GFOA offers Advanced Public Investing in Chicago in July**

Advanced Public Investing, scheduled for 9 am to 5 pm on Monday and Tuesday July 18 & 19, will provide participants a solid understanding of complex investment concepts that pertain to risk, reward, portfolio strategies, and structured security analysis. Participants will be expected to have a good foundation in types and characteristics of fixed income securities, investment economics, and passive and active investment strategies. It is strongly recommended that participants attend the GFOA Investing Public Funds seminar before attending this Advanced Public Investing seminar.

Cost for GFOA members is \$550; non-members pay \$750. The course is 16 CPE credits.

For more information visit <https://www.gfoa.org>