Illinois Public Pensions

A pension management and investment newsletter for Illinois pension funds
published by the Illinois Government Finance Officers Association Spring 2007

TABLE OF CONTENTS

IMRF rebuttal to the Civic Federation..2

Sudan Divestiture Act declared unconstitutional 5

IML pension fund fiscal analysis released 6

Chicago Federal Reserve Summary of the 2006 State and Local Government Public Pension Forum 6

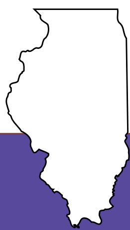
Illinois Public Pensions Institute featured speakers..........................15

Excerpts from Predatory Lending in Illinois: An overview..............16

Funding OPEB liabilities 19

GFOA publishes new Recommended Practices.................................24

IGFOA Pension Management programs..29



www.igfoa.org

Illinois Public Pensions

Illinois Public Pensions is published quarterly by the Illinois Government Finance Officers Association (IGFOA),
1120 E. Diehl Rd.,NIU Naperville Campus, Naperville, IL 60563; phone 630-505-0679, www.igfoa.org.

Annual subscription rates are: Public Sector IGFOA member rate – $35 plus $1 for each additional newsletter to same subscriber;
Associate IGFOA member rate – $50 per year/subscriber; Public sector non-member rate – $100 per year/subscriber;
Private sector non-member rate – $100 per year/subscriber.

The information and opinions printed herein are obtained from sources believed to be reliable, but IGFOA makes no guarantee of accuracy.
Opinions, forecasts and recommendations are offered by individuals and do not represent official IGFOA policy positions.
Nothing herein should be construed as a specific recommendation to buy or sell a financial security.
The publisher and author specifically disclaim any personal liability for loss or risk incurred as a consequence of the use and application, either directly or indirectly, of any advice or information presented herein.

©2007 Illinois Government Finance Officers Association

IMRF rebuttal: A response to the Civic Federation Article on pension board reform

by Louis W. Kosiba, Executive Director, Illinois Municipal Retirement Fund

IMRF advocates existing autonomy of plan administration and investment authority

The year 2005 was a watershed for IMRF in at least two aspects. First, two bills were introduced into the Illinois General Assembly which, if passed, would have seriously affected IMRF operations. One bill would have expanded our Board of Trustees from eight to ten. It would have guaranteed two seats to Sheriffs' Law Enforcement Personnel (SLEP) while allowing SLEP participants to also run for election for the other eight seats. The second bill would have transferred all investment authority for IMRF assets to the Illinois State Board of Investments. The second watershed event was the adoption of a formal Strategic Plan for the first time in the history of IMRF. One of our strategic goals is to ensure members and employers retain control of key decisions through an elected board. A key attribute leading to IMRF's funding success has been an independent Board of Trustees with the power to invest assets and set employer contribution rates based on sound actuarial principles.

In the Spring 2006 issues of *Illinois Public Pensions*, Lise Valentine of the Civic Federation called for public pension board reform. She argues citizen members should have one-third the seats on public pension boards with the remaining seats divided equally between management (employer) and current and retired employee representatives. She further argues for the inclusion of financial experts on pension boards and for mandatory financial training for non-expert trustees.

In the first paragraph of her article, Ms. Valentine identifies two problems plaguing state and local public pension funds in Illinois: (1) increasing pension benefits; and (2) skipped or reduced employer contributions. Neither problem affects IMRF. Moreover, her solutions (citizen representation and financial experts on pension

boards) will not solve the identified problems. To put it another way, she seems to argue that if boards had citizens and professionals as trustees, benefits would not increase and contributions would not be skipped. I disagree.

The proposal raises additional questions: (1) Who would appoint citizens to boards? (2) How would you keep politics out of the citizen selection? (3) Would the citizen appointees try to curry favor with their appointor?

Develop a tripartite structure

The Civic Federation argues that if citizens were members of Boards, benefit increases would not occur and contributions would not be skipped. Ms. Valentine presents no evidence that either problem would be solved in Illinois through the Federation's proposed solution.

I believe unions and employee associations pass benefit increases—not Boards. Since 1997, the IMRF Board of Trustees has supported 5-year vesting for members (a benefit increase). We believe this is an appropriate modernization of the IMRF program placing us in the same position as the private sector. Five year vesting for IMRF members has never passed the General Assembly, because this cause has not been championed by the groups that are listened to in Springfield.

I have attended enough Pension Committee hearings in Springfield to know the Public Pension Systems are seen merely as administrative resources for information. They are not seen as effective advocates for benefit increases. The legislators look to unions and employee associations to understand what benefit increases should be passed.

Similarly, citizen representation on an Illinois Public Pension System will not result in actuarially sound funding when the State or local unit of government wants to balance its budget by shortchanging the pension funds. Even laws have not accomplished that. In 1995, Illinois famously adopted a 50-year/90% funding goal statute requiring contributions to the five State funded systems. But in 2005, that statutory provision was suspended to balance the budget. When the hard choices have to be made in Springfield (both political and financial), hav-

ing citizens occupy one-third of the trustee seats will not make a difference.

Include financial experts on pension boards

If IMRF or the other boards had poor investment returns, the addition of financial experts on boards would make sense. Ms. Valentine does identify "recent declines in investment returns" as one cause for the negative outlook faced by public pension funds. We all recognize the market downturn in the 2000-2002 period. However, she has not questioned the investment returns of the Illinois Public Pension Systems. She has provided no statistical evidence the Illinois systems performed worse than the overall downward trend. Similarly, she has provided no statistical evidence that Boards with experts outperformed boards without experts over this period of time.

Her argument ignores the fact that each major Public Pension Board in Illinois employs professional investment staff, investment consultants, and hires professional investment managers. The smaller police and fire Boards may not hire consultants or have a professional investment staff. Many of those local funds however, do use mutual fund managers to assist in decision-making.

Boards serve important oversight capacities. Yes, trustees need to understand, ask questions and challenge staff and consultants. Yes, trustees should seek and obtain financial training.

However, no logical connection exists between having financial experts on boards and funding or benefit increases. Warren Buffet could serve on any state-funded board in Illinois and the state would still underfund pensions to balance its budget and the legislature would still grant benefit increases.

The real challenge to investment returns are the new restrictions and mandates on investment operations being placed by the Illinois General Assembly. The Civic Federation could perform a valuable service by monitoring how these new restrictions are and will hobble investment returns.

Conclusion

What ails the Public Pension Systems in Illinois is a structure which allowed underfunding in the past. However, the future arrived and there are hard decisions to be made in the political arena. Juggling boards is a meaningless activity which may make some feel good because it appears to solve the problem. But, at the end of the day, it is sound and fury signifying nothing.

And, by the way, the one retirement system she believes explicitly requires its board to include some members with experience and competency in financial and business management is the same board whose "expert" was indicted. It is also the board which justified paying investment manager finders fees. Something IMRF does not do. Trustees who also participate in the Retirement System at least have a stake in its financial well-being.

The Civic Federation has shown an interest in talking about the funding problems for the State and local public pension funds. It needs to do more work in developing effective solutions.

Sudan Divestiture Act declared unconstitutional

A Federal District Judge ruled to permanently enjoin the State of Illinois from enforcing the Sudan Divestiture Act because the court deemed the Act unconstitutional.

The National Foreign Trade Council (NFTC), which is a trade group representing a majority of Fortune 500 companies, brought the suit against the state in early August 2006. A small number of police and firefighter pension funds also joined the suit. The law was declared unconstitutional because it interfered with the federal government's authority over foreign affairs and commerce.

The NFTC won a similar suit in 2000, which they brought against a Massachusetts law that prohibited investments in Burma. This recent ruling is likely to affect actions in a number of other states that passed

similar laws. The Illinois case garnered national attention because it was the first law passed and subsequently challenged.

Read the court ruling's full text at
http://www.igfoa.org/documents/SudanDecision.pdf.

IML pension fund fiscal analysis released

The Illinois Municipal League recently released a fiscal analysis of downstate and suburban police, fire and IMRF pension systems. It can be found at www.iml.org. Kudos to Tim Sexton, Assistant Finance Director, Village of Lombard for his work with IML on this project!

Chicago Federal Reserve Summary of the 2006 State and Local Government Public Pension Forum

by Richard H. Mattoon, senior economist and economic advisor

As growing numbers of their work force approach retirement age, state and local governments are taking a hard look at their pension funds to see if they are prepared for this exodus. This one-day conference brought together policymakers and experts to weigh the state of these funds.

The future of state and local government public pension systems and related health care liabilities was the subject of a conference held at the Federal Reserve Bank of Chicago in February 2006. The conference was cosponsored by the Bank, the Civic Federation, and the National Tax Association and brought together pension experts from law, accounting, and economics to discuss public pension dynamics and future liabilities.

Influence on recruiting and retaining talent

Lance Weiss and Tim Phoenix from Deloitte

Consulting began the program by discussing the influence that pension structure and benefits can have on recruiting and retaining talent in the public sector. While public sector leaders often recognize that an aging government work force is a significant issue, they are often at a loss on how best to manage pension obligations to meet the needs of both government employees and taxpayers. Public sector demographics suggest that a large portion of government workers are approaching retirement age, and this could lead to a significant talent gap. To manage this issue, Phoenix suggested governments look at their work force supply and demand strategies to ensure that they have the appropriate knowledge capital to meet their needs. The supply strategies include targeted strategies for improving attraction and recruitment, as well as realigning retirement and reward programs to retain and potentially extend the longevity of key employees. They also include better talent development programs and transferring knowledge from experienced workers before they retire, as well as investigating flexible employment options. On the demand side, various productivity enhancing strategies are key. These include expanding use of automation, investigating outsourcing, and providing self-service for customers.

An overview of pension fund dynamics

Lance Weiss followed with an overview of pension fund dynamics. Weiss stressed that the public pension environment has changed radically, driven by new accounting requirements, such as Government Accounting Standards Board (GASB) No. 45, that force governments to recognize health care and other nonpension expenses and changing expectations for the role of the employer in providing retirement benefits. These nonpension expenses are referred to as "other postemployment benefits" (OPEB). The era of employer paternalism is being replaced by one of employee empowerment, with the risk of saving for retirement shifting to the employee. Weiss suggested that states have two basic options for addressing a pension funding shortfall. First, they can cut costs by reducing basic and/or ancillary plan benefits, or trim administrative expenses.

Second, they can increase investment returns or find alternative funding sources. They can defer costs by changing funding policies, changing actuarial assumptions or funding method, or changing the asset valuation method. Weiss stressed that deferral strategies will do little to address fundamental drivers of pension fund solvency. Weiss concluded that any strategy to fix pension shortfalls or reduce benefits must recognize the sensitivity many government employees have about their retirement benefits.

A panel of major rating agencies

Richard Ciccarone of McDonnell Investment Management moderated a panel of major rating agencies. Ciccarone noted that, from the perspective of an institutional investor, the key questions in the public finance market are: Do the ratings provided by the rating agencies provide investors with sufficient warning of deteriorating financial condition? Second, do bond prices reflect the risk of the issuer? In both cases, Ciccarone suggested that even within the same rating category, the issuing governments often appear to have widely differing underlying financial strength. For example, public debt instruments rated as AA include those of states such as Illinois, West Virginia, Rhode Island, and Connecticut. All of these states have pension funds with funding ratios below 75%, and yet there is little effect on their debt rating. He also noted that investors have been willing to purchase riskier bonds, such as the Illinois pension bond offering of 2004, without requiring the bonds to pay a premium, suggesting that the market does not do a better job at pricing risk. He concluded that some of this might be due to bond insurance that often makes the underlying quality of the issuer immaterial to the investor.

The first of the presentations by the rating agencies was **John Kenward of Standard & Poor's**. Kenward noted that the deterioration in public pension solvency has been very rapid and driven by the confluence of unfavorable demographics, stock market declines in 2000 and 2001, and the enhanced pension benefits during the strong revenue growth years for many states in the 1990s. The aggregate funded ratio for state governments went from 100% in 2000 to 84% in 2004. Noting that pen-

sion and OPEB obligations will be with state and local governments for some time to come, he suggested that policies will likely need to address both the asset and liability side of the balance sheet. For example, the state of Oregon undertook a sweeping reform of its pension program that included closing the defined benefit program to new hires. It also sold $2 billion in pension obligation bonds and created a new hybrid program for new employees. Finally, Kenward stressed that Standard & Poor's will continue to examine management, financial condition, and debt level, as well as macroeconomic factors, in determining governments' creditworthiness.

Paul Nolan of Moody's Investor Service spoke about OPEB exposure. He stressed that, in the long term, the OPEB requirements will improve the financial transparency of government but will create several short-term headaches. The GASB No. 43 and No. 45 will require governments to go from a pay-as-you-go system for funding nonpension retiree benefits (largely health care) to a structure in which future liabilities must be reflected on the government's accounting statements. In assessing the ability of any particular government to meet its OPEB liabilities, Moody's will look at the size of the liability relative to potential revenues and to peer governments. Like Standard & Poor's, it does not anticipate wide-scale credit reductions, assuming that most governments will have a reasonable plan for meeting liabilities. Nolan anticipates that governments will begin to prefund health care expenses as well as consider issuing OPEB bonds to meet obligations. Depending on the contractual requirements, reductions in benefit coverage will also be considered.

Joseph O'Keefe of Fitch Ratings noted some other considerations pressuring public pensions. First, attempts to change benefit levels are becoming increasingly critical in any labor negotiations, and attempts to shift from defined benefit to defined contribution pension programs are frequently met with resistance from public employee unions. Second, new state employees are often receiving less generous pension options than vested employees. Finally, many actuarial studies suggest that contribution rates are lagging benefit costs, suggesting that the problem will become worse before it improves.

O'Keefe noted that many governments are increasingly looking for external financing options. In particular, pension bonds have been growing in popularity. He stressed that while issuing bonds is often an appropriate strategy, it has some distinct risks. Since it is based on an arbitrage strategy of capitalizing on higher investment returns from the bonds' assets relative to the cost of the issued bonds, market timing is critical. In addition, in using bonds, the government takes a "soft" debt (i.e., one that it has flexibility in funding) and turns it into a "hard" debt that requires meeting annual defined payouts.

Michael Moskow, President and CEO of the Chicago Fed, offered his perspective on pension issues and their regional implications. To begin, Moskow noted that public pensions are not subject to the same ERISA (Employee Retirement Income Security Act) rules that govern private pensions. This has made it easier to increase pension benefits to public sector retirees without assuring adequate funding. In addition, private pensions have been radically restructured. Only 11% of private firms continue to offer defined benefit programs in which retirees are guaranteed a monthly income for the rest of their lives. Nearly 90% of public pensions are still defined benefit plans, and many of them include annual cost of living increases that increase liabilities even further. In contrast, private firms have moved to defined contribution plans and 401(k) programs where retirement payouts are based on the employee and company contributions to the plan. A key issue is whether defined benefit plans are the best mechanisms for providing state and local employee pensions, or whether a move toward defined contribution plans would be appropriate.

Moskow suggested that pension issues are even more acute in many midwestern states. In states with high population and personal income growth, future increases in tax revenues may allow these states to catch up on their pension imbalances. In addition, states with favorable demographics and younger state and local government employees will be slower to feel the bite of pension payouts. Unfortunately for some of the Midwest, state and local pensions are similar to the legacy costs that

domestic automakers face. They are a financial burden that may hurt the competitiveness of these states in the future.

To address this issue, Moskow observed that we need to have a better sense of the size of the pension obligation. More uniform accounting standards are likely needed to evaluate the true health of public sector pensions. Beyond this, it is likely that pension plans will need to be structurally changed, including identifying new funding sources and restructuring pension payouts. This will be no easy matter, given that many state and local government pensions have strong legal protections that make restructuring current plans difficult, if not impossible. Finally, solving the pension problem is more than an accounting exercise. Pensions must be recognized as part of any employee's total compensation program. Pensions have been structured to meet firms' and organizations' goals of retaining key staff and building a productive work force. The human capital dimension is an important consideration in redesigning pension programs of today's employees. For private firms, the movement to defined contribution and 401(k) programs recognizes the increased mobility of today's work force. Pension portability better meets the needs of today's private workers. Pension programs need to reflect the needs of organizations in meeting their human capital requirements. No one-size-fits-all plan will be appropriate.

Next, **Fred Giertz of the University of Illinois** and the National Tax Association contrasted the condition and structure of state and local government pensions to those of social security and private pensions. The magnitude of the financial liability of the programs is significantly different. The future liability for Social Security and Medicare is $38 trillion, which represents 362% of gross domestic product (GDP). The high-end estimate of state and local pension funding liability is at $700 billion or 6% of total gross state product (GSP). Even in states with particularly acute problems, such as Illinois with an unfunded liability of $38 billion, this represents only 6% of that state's GSP. Private sector pension exposure is estimated at $450 billion (4.3% of GDP), and some of that exposure is limited by the Pension Benefit Guaranty Corporation (PBGC).

Giertz next turned to resources available to meet the problem. The federal government has the broadest resources with both broad monetary and tax powers. While states have reasonably broad taxation powers, they are limited by interstate competition in exercising them too aggressively. They also can increase revenues through fees and other nontax sources. Private pension resources must draw from company operations or, in the case of a bankruptcy, the PBGC. Giertz noted institutional constraints that might interfere with appropriate actions. For Social Security, solving the problem has been likened to the third rail of American politics. There is no solution that will not cause significant pain to a given constituency, making it easier to simply defer the problem. State governments similarly have used pension underfunding for implicit borrowing to fund other programs. As such, it is often the manifestation rather than the cause of state fiscal problems. Giertz noted that pensions are often targets of political influence. This can range from outright corruption to more subtle limitations that reduce returns by raising administrative costs to limiting investment options.

Giertz concluded that political will is the key to addressing state and local pension shortfalls. This is a large but manageable problem; however, to ensure that state and local governments do not revert to their old ways, some structural reforms to pension administration may be worth examining.

James Spiotto of Chapman and Cutler provided a legal perspective on pension fund issues. A key question is whether pensions are a vested right of the employee or a voluntary gratuity provided by the employer. As a vested right, many governments include nonimpairment clauses that make it difficult to restructure pension or OPEB benefits if the plan is under financial duress. However, there are varying levels of protection, ranging from strict constitutional rights to general statutory provisions, that might allow for some renegotiation of benefit levels in light of adverse conditions affecting the pension fund.

Spiotto noted that the difference between “unwillingness to pay” and “inability to pay” is important in under-

standing how governments should deal with their pension issues. Governments with an inability to pay face a major public finance problem that will require restructuring government programs and revenues to meet their obligations. This might even lead to governments seeking bankruptcy protection from the court. Spiotto noted that states cannot go bankrupt; however, they can repudiate debt. Local governments have more options. They can file for a Chapter 9 bankruptcy that allows adjustment of debt or debt payments; however, this requires state authorization. Courts have permitted the alteration of pension benefits under Chapter 9 filings. Spiotto concluded that pension obligations can best be met when funding is clearly identified (and even specifically dedicated) to meet obligations.

Hank Sheff of the Association of Federal, State, and Municipal Employees (AFSME) Council 31 offered organized labor's perspective on pension funding. Sheff noted that public employee unions strongly favor defined benefit programs. Not only do these better meet the needs of public employees, but Sheff argued that they are more cost effective to operate. He noted that pensions are more critical to many public workers, given that nearly one-quarter of them do not receive Social Security benefits. Sheff noted that many public pension plans are in fact well funded but that only those with the greatest problems make the national media. Illinois, for example, has one of the most comprehensive problems that can largely be blamed on systematic underfunding of pension liabilities over an extended period of time. Underfunding pensions allowed the state to mask other fiscal problems, including a tax structure that has failed to grow fast enough to meet state obligations. While Illinois has adopted a plan to restore pension solvency, Sheff noted that it requires very steep state contributions that would reach almost 23% of total payroll by 2011.

Sheff concluded that the Illinois pension's future looks bleak unless new taxes are considered. For public employees, solutions that would diminish benefits for future workers or cut state programs would be draconian solutions.

Lise Valentine of the Civic Federation presented recent research on the structure of pension boards. Valentine suggested that pension boards should be structured to be free of political influence and focus entirely on safeguarding the assets of the fund through prudent investment and effective management. In particular, pension boards should not engage in advocating for a particular group of stakeholders.

Valentine's research suggested that best-practice states require the participation of citizen members who are not fund beneficiaries and/or independent financial experts. Examples include the Maryland State Retirement System, the Texas Teachers System, and Virginia's state program. These programs balance employee and management representation and have a structure that requires independent citizen participation. They also have financial experts and focus on optimal stewardship for fund assets. Valentine urged that Illinois pension funds adopt such a structure.

Conclusion

Conference participants generally concluded that pension and OPEB liabilities will prove to be a major fiscal challenge for state and local governments for some time to come. While the depth of the problem will vary from place to place, these liabilities will pressure government balance sheets and require many governments to take a hard look at available revenues and expenditures to meet the retirement needs of their employees and still maintain government functions.

The Chicago Fed will continue to investigate pension issues. Please visit the conference website at www.chicagofed.org/news_and_conferences/conferences_and_events/2006_government_pension_agenda.cfm to download conference presentations and share ideas on our pension blog.

Chicago Fed Letter and other Bank publications are available on the Bank's website at www.chicagofed.org.

Rick Mattoon is a senior economist and economic advisor in the economic research department of the Federal Reserve

Bank of Chicago. Mattoon's primary research focuses on issues that face the Midwest regional economy. His analysis of electricity restructuring and energy issues, higher education policy, regional economic development and state and local government finance has appeared in numerous publications. Mattoon also serves as an adjunct associate professor at the Kellogg School of Management at Northwestern University.

Hear more from Rick Mattoon at the Illinois Public Pensions Institute on April 27.

See the back of this newsletter for details on the Institute, and read Rick Mattoon's blog on pension matters at http://pensionconference.chicagofedblogs.org/

Illinois Public Pensions Institute featured speakers

- **Rick Mattoon**, Senior Economist and Economic Advisor in the economic research department of the Federal Reserve Bank of Chicago, THE 2006 YEAR IN REVIEW: Mattoon's primary research focuses on issues that face the Midwest regional economy. His analysis of electricity restructuring and energy issues, higher education policy, regional economic development and state and local government finance has appeared in numerous publications.

- **David Weiss, MD,** The Medical Insurance Consulting Group, Inc., THE NATURE OF DISABLING INJURIES: Dealing with confounding disability claims? Gain a better understanding of how disabilities affect public safety employees and how Pension Boards can address claims.

► **Calene Zabinski,** Zabinski Consulting Services, Inc. and IGFOA Technical Accounting Review Committee (TARC) member, GASB UPDATE What's GASB have in store for pension fund accounting and reporting? TARC recently reviewed the exposure draft for pension disclosures, an amendment of GASB statements No 25 & No 27. Learn about the committee's recommendations to GASB and gather information about other GASB initiatives.

► **David A. Richardson**, Finance Director and Treasurer, Village of Streamwood and IGFOA Legislative Committee Chair, UPDATE ON PUBLIC PENSION LEGISLATION: Join us for the latest news on the Illinois 95th General Assembly legislative proposals pertaining to Downstate Police and Firefighter Pension Funds.

► **Daniel Ryan,** Administrator, UFCW Unions and Employer Midwest Health Benefits and Pension Funds, Trustee for the Skokie Police Pension Fund and Past IGFOA President, WEBSITES FOR PUBLIC PENSION PLANS: The merits of a well-designed website for Downstate Police and Firefighter Pension Funds. Mr. Ryan was Chief Financial Officer of the municipal government in Skokie, and has served as a police pension trustee and founding trustee of two multi-government cooperatives.

► **Richard J. DeCleene,** Chief Financial Officer, Illinois Municipal Retirement Fund, IMRF UPDATE: In a February 2007 Crain's Chicago Business article, Laurence Msall, president of the Civic Federation noted, "The IMRF is the model of fiscal responsibility that all policymakers in Illinois should be following." Learn about IMRF's recent accomplishments and initiatives.

See back page for details or visit www.igfoa.org/seminars.html to learn more and register

Excerpts from *Predatory Lending in Illinois: An overview*

Report prepared by the Association of Illinois Public Retirement Systems, July 25, 2006

Section 9: Issues: Open and Closed

As a preliminary point, it is important to acknowledge that predatory lending is a practice which needs to be stopped in Illinois, as well as nationwide. It is not in the best interests of taxpayers or public pension plans for this activity to continue. The Association of Illinois Public Retirement Systems is working to square sound public policy with established fiduciary responsibilities placed on trustees, staff and investment managers.

That said, there are several open issues which the pension plans will need to address, perhaps without the benefit of further guidance from the State or the Community Advisory Groups. Similarly, there are some issues which may be deemed settled as a practical matter.

Open Issues (Is Certification Required?)

None at this time.

Closed Issues

1. There is no definitive, exhaustive list of predatory lenders, nor will there be one.

2. A predatory lender can be any financial institution which makes, offers, deals in or transfers, high-risk loans.

3. Predatory lenders do not include purchasers, assignees or subsequent holders of high-risk loans.

4. "Financial institution" means a bank, savings and loan association, thrift, credit union, mortgage banker, mortgage broker, a trust company, a savings bank, an investment bank, a securities broker, a municipal securities broker, a securities dealer, a municipal securities dealer, a securities underwriter, a municipal securities underwriter, an investment trust, a venture capital company, a bank holding company, a financial services holding company, or any licensee under the Consumer Installment Loan Act, the Sales Finance Agency Act, or the Residential Mortgage Licensing Act which makes res-

idential loans. However, “financial institution” specifically shall not include any entity whose predominant business is the providing of tax deferred, defined contribution, pension plans to public employees in accordance with Sections 403(b) and 457 of the Internal Revenue Code.10

5. Only financial institutions doing business in the United States are covered.

6. Depositories of pension assets must provide certifications.

7. If the Fund does business with a financial institution, as an investment manager, certification is required.

8. Certification is not required of financial institutions in which the Fund has invested through an investment manager. (Funds will not look through the investment management relationship to determine if instruments it owns were issued by a predatory lender.)

Section 10: Approach

Given the broad range of public pension plans in Illinois, the diversity of investments and the open issues, it may be impossible to develop one consistent approach which furthers a worthy public goal, while at the same time shielding the trustees, staff and investment managers from fiduciary liability.

That said, the various retirement systems agree to develop, as much as practicable, a consistent approach and action plan.

Action Plan

1. Boards of Trustees will adopt the resolution proposed by the Speaker condemning predatory lending, including the certification. The resolution should be distributed to all custodians, consultants and investment managers.

2. Require the Fund’s Master Trustee or bank depositories to execute the certification adopted by your Board.

3. Require the Fund’s consultants to acknowledge in

writing the Board's position condemning predatory lending.

4. Send a questionnaire to each investment manager to determine which are/are not financial institutions engaged in sub-prime lending.

5. Require the Fund's investment managers (which are financial institutions) to execute the certification. If they cannot, determine the reason. Work for a compromise, an amended certification, or terminate the investment manager.

6. Support federal legislation which either curtails federal preemption thereby allowing state regulation of predatory lending, or which establishes a federal prohibition of predatory lending.

[10] Chicago Municipal Code §2-32-455 (2000)

Find the full report at http://www.igfoa.org/whtpaperfinal.pdf.pdf and more resources on predatory lending at http://www.igfoa.org/PensionPredLending.html.

Funding OPEB liabilities

by Jim Spice, Finance Director, City of Kankakee from the IGFOA Technical Accounting Review Committee OPEB webcast

How will our governmental units manage the actual financial impact of Other Post Employment Benefits (OPEB) liabilities? Will the government fund the plan, or will it continue on a pay as you go (or PAYGO) basis? And, what are the implications of these two alternatives?

I must admit, I have probably been somewhat naive about the implications of GASB 45 and its effect on the City of Kankakee. I have been of the opinion that because the City has only implicit costs, GASB 45 would not have too much of an effect on the City. I believe as we continue to explore this issue, we will see that even the implicit costs are trending to be substantial.

But first, it is important to note that GASB 45 does not

require advanced funding. If a government chooses to continue on a PAYGO basis, that decision alone will not impact the unit's audit opinion; an unqualified opinion is still available.

Having said that, it is noted that governments that do fully fund each year's annual required contribution will not have to report a liability on their financial statements. However, the government will have the impact of providing the funding.

There are advantages to deciding to advance fund

There are several advantages to a government's decision to advance fund (i.e. establishing a trust) for the OPEB. For example, as the liability is determined, a discount rate is used to determine the present value of all future post employment benefits that are expected to be received by each retired member and by each active employee. One advantage to advance funding is that GASB 45 does provide that a higher discount rate can be used for assets that are held in a separate trust because those assets are generally held in higher yielding investments than the City's shorter term funds are held. Conversely, when a government decides to continue on a PAYGO basis and not fund a trust, GASB 45 requires the discount rate to reflect the regular earnings rate available to the government, or the rate its short-term and fixed income securities are earning. Additionally, on a PAYGO basis, both the unfunded actuarial liability and the net OPEB obligation will grow.

If a government decides to partially fund the OPEB, a blended discount rate should be used. Funding the trust at some level has the effect of reducing the government's unfunded liabilities and reducing ongoing annual expenses.

Another way of stating the advantage to funding the OPEB is that the longer a government puts off funding, the greater will be the long-term effects and the greater will be the annual budgetary impact each year in to the future. An example shared with me by Fred Lantz of Sikich LLP was the City of Aurora, which incidentally does have a richer benefit plan than just the implicit cost from a retiree paying the full premium to stay on

the employer's plan, has determined that its current liability is about 2.5% of its current general fund operating budget. Its liability was projected to grow to 18.5% of the general fund balance in 10 years if the OPEB liability was not funded.

Fred noted that Aurora recently issued bonds, and that this matter was addressed by Standard and Poor's in determining Aurora's bond rating. Aurora actually received an upgrade in rating because S&P recognized the leadership position that Aurora took on this issue when it determined that it would take a proactive stance in managing the OPEB costs by funding those benefits.

Another example Fred cited was Alan Greenspan's analysis that the federal government's OPEB liability, currently projected at 1 to 2% of the budget, is projected to grow to 17 to 19% of budget in the next 10 years. So, we might want to reconsider and hold back our opinion on whether the implicit costs will or will not have a large impact to a governmental unit until we learn what the actuarial numbers are.

Most of us are addressing the funding matter

The major disadvantage of advance funding is the budgetary stress a lot of governments are under. It is easy for the governing body to promise future benefits to its employees without taking into account how much it will ultimately cost taxpayers by not recognizing and currently funding the future costs of OPEB's. So, taking the approach of continuing to fund on a PAYGO basis might be a short sighted solution, from the literature I have found on the subject, most governments are planning to fund at some multiple of the OPEB liability, so most of our colleagues are planning to address the funding matter, at least to a partial extent.

So, what are the actions and/or alternatives that we can recommend to manage the costs that will be made more obvious by the GASB 45 reporting requirements? Any actions we do take will have to be evaluated in light of existing bargaining unit agreements and requirements set forth in the Illinois Compiled Statutes.

One thing we should do is make our governing bodies aware of the implications of accounting for OPEB's so they can be more alert to the impacts legislative initiatives have on the governmental unit and to the impact that the post employment benefits that are offered by a governmental unit to attract and retain employees. We will also want to alert them to the costs related to the various state mandated benefits. One example of a state legislature-imposed unfunded liability passed on to local governments is the recently enacted requirement for governments with public safety employees (policemen and firefighters) to provide fully paid lifetime health coverage for public safety officers and their dependents when the public safety officers incur duty-related disabilities. The actuaries will likely be considering this area as their experience in developing the actuarial studies matures.

Actions we'll want to take

We might not have much flexibility in addressing the issue brought about by the implicit costs other than funding considerations, but we will want to review the entire slate of post employment benefits to look for areas that might call for adjustment. We will want to write policies to document how post employment benefits are managed and administered. We will want to make the governing body cognizant of the costs that providing post employment benefits will have on tomorrow's taxpayers, including the implicit costs of the state requirement for governments to allow their retirees to continue on the government's insurance plans while the retiree pays the full premium rate at which the employer provides the same coverage to its active employees.

Some of our governments do provide a richer array of post employment benefits than merely the continuation of the retiree health benefits, such as when the government agrees to pay for all or a greater portion of those benefits than required by the Illinois Compiled Statutes. As the GASB 45 reporting goes into affect, it will become more apparent that those promises can carry significant long term financial ramifications.

We can recommend that our governments start accumulating assets (or start setting money aside) to finance the retiree health benefits.

If the government is providing lifetime benefits, it might consider the feasibility of changing to an end at age 65 benefit.

The government can evaluate the feasibility of reducing benefit levels. This would be accomplished by creating different tiers of benefit levels for new employees or new retirees, possibly based upon tenure, again, as is consistent with Illinois Compiled Statutes and various bargaining agreements.

The government could switch to an individual account based approach to retiree health coverage, either funded or unfunded, with the use of HRA's or HSA's.

Within the constraints of *Illinois Compiled Statutes* and/or bargaining agreements, the government could consider setting contribution requirements that vary by years of service (I understand that age cannot be a consideration).

The government could consider using a different plan design for retirees than it uses for its active employees. An example would be the use of a high-deductible health plan.

Finally, the government could consider placing a cap on the maximum amount of employer provided subsidy.

In conclusion, regarding the funding considerations of GASB 45, we want to make sure not to forget to plan for an increase in the audit costs that will be incurred from the implementation of the requirements of this statement.

I have heard GASB 34 referred to as the full employment act for accountants and engineers. In light of that, it seems that GASB 45 could equally be referred to as the full employment act for actuaries.

GFOA publishes new Recommended Practices

Approved by the GFOA's Executive Board on March 2, 2007

Need for Considerable Caution in Regard to OPEB Bonds (2007)

GASB Statement No. 45, Accounting and Financial Reporting for Employers for Postemployment Benefits Other than Pensions, requires public-sector employers to disclose in the notes to the financial statements the full amount of their unfunded actuarial accrued liability (UAAL) for other post-employment benefits earned by employees for services rendered to date. In addition, employers who subsequently fail to fully fund their actuarially determined annual required contribution (ARC) each year will also be required to report the cumulative effect of underfunding the ARC as an accounting liability on the face of their financial statements. Nothing in GASB Statement No. 45 requires employers to advance fund their OPEB obligations. The decision to advance fund OPEB should reflect a given jurisdiction's careful analysis of its own unique financial situation.

Recommendation

Despite the similarities between OPEB bonds and other types of debt as financial products, the analysis needed to determine their appropriateness is substantially different. Therefore, GFOA strongly recommends that jurisdictions contemplating the possibility of issuing OPEB bonds not only follow the guidelines already set forth in GFOA's recommended practice on pension obligation bonds, but also do all of the following:

- Allow sufficient time for a public-policy dialogue to occur between the governing body, employee groups, finance officials, and the public they serve regarding the appropriate funded ratio for OPEB. Failure to do so could produce "solutions" that ultimately fail to reflect the desires and considered judgment of constituents.

- Consider OPEB bonds only upon consultation and advice from a knowledgeable financial advisor who is not also serving, or planning to serve in the future, as an underwriter of the OPEB bonds. As part of their consideration, potential issuers should compare the results of any proposed OPEB bond issuance to both (1) advance funding on the basis of the ARC and (2) pay-as-you-go funding.

- Refrain from issuing OPEB bonds until all issues concerning the proper establishment of a qualified trust fund, investment procedures, and investment guidelines have been resolved.

- Consider, upon consultation with actuaries and other experts, limiting the planned funded ratio to an amount suggested by actuarial and other analysis.

In summary, GFOA urges governments to exercise considerable caution when contemplating the possibility of issuing OPEB bonds.

Use of Local Government Investment Pools (2007)

In many states, the state treasurer or an authorized governing board (a local government such as a county) oversees a pooled investment fund that operates like a mutual fund for the exclusive benefit of governments within that state. These state pools typically combine the cash of participating jurisdictions and invest the cash in securities allowed under the state's laws regarding government investments. By pooling funds, participating governments benefit from economies of scale, full-time portfolio management, diversification, and liquidity (especially in the case of pools that seek a constant net asset value of $1.00). Interest is normally apportioned to the participants on a daily basis, proportionate to the size of the investment. Most pools offer a check-writing or wire transfer feature that adds value as a cash management tool.

Government Sponsored vs. Joint Powers Agreement Pools

Local government investment pools (LGIPs) may be

authorized under state statutes and sponsored by the state or local governments or may be set up through intergovernmental agreements known as "joint powers" agreements. Government investment pools operated for local governments generally are authorized by statutes and permit the state or local treasurer or appropriate agency to pool investments and distribute income to the participating local governments. In some cases, state funds are commingled with local government funds; in other cases, the pools consist only of local government funds. Generally, the pool's portfolio manager may purchase only the same investment instruments permitted for state and local governments in that state. A few states permit a broader list of allowable instruments.

Not all pools are the same

Although there are many similarities between the various LGIPs, there are also many differences. One such significant difference among pools that must be understood before placing money in them are their investment objectives. When LGIPs were first created, most emulated money market mutual funds with the objectives of maintaining a "constant" Net Asset Value (NAV) of $1.00 and providing excellent liquidity for the investor. Such LGIPs invest in short-term securities with average maturities sufficiently short to avoid market price risk. The "constant" NAV pools are appropriate investments for funds that must be liquid and have virtually no price volatility.

By comparison, there are also government investment pools with the investment objective of maximizing return. These pools invest in longer-term securities, subjecting their portfolios and their participants to greater market price volatility. These pools are variable Net Asset Value (NAV) pools and introduce market risk to the investor through a fluctuating NAV. The principal invested in the pool may not be the same principal returned to the investor depending on the movement of interest rates. These pools would not be appropriate for funds that must be liquid and stable. They may be appropriate for longer-term strategies.

Some other differences among pools include their legal structure, authorized investments, procedures for

depositing and withdrawing money, and their services. Each pool has a process that a participant must complete, including documents to be signed and banking information to be provided, in order to establish an account. Sources of information for evaluating pools may include a pool offering statement, investment policy or audited financial statements.

Ratings for LGIPs

Investors should remember that LGIPs are not registered with the Securities and Exchange Commission (SEC) and are exempt from SEC regulatory requirements because they fall under a governmental exclusion clause. While this exemption allows pools greater flexibility, it also reduces investor protection. Investments in these pools are not insured or guaranteed and substantial losses have occurred in the past. Some rating agencies rate LGIPs using the same criteria as money market mutual funds. These ratings are based on safety of principal and ability to maintain a NAV of $1. Pool ratings can provide an additional method of due diligence.

Recommendation

The Government Finance Officers Association (GFOA) makes the following recommendations to government investors when using Local Government Investment Pools (LGIPs):

1. Government investors should confirm LGIPs are eligible investments under governing law and the government's investment policy.

2. Government investors should fully understand the investment objectives, legal structure and operating procedures of the investment pool before they place any money in the pool. When evaluating an LGIP, investors should read the pool's offering statement, investment policy, audited financial statements carefully.

3. Particular attention must be paid to the investment objectives of a pool to determine whether a pool seeks to maintain a constant NAV of $1.00 or could have a fluctuating NAV. This information is essential

in order to determine which pools are appropriate for liquidity strategies (constant NAV) and which ones are only appropriate for longer-term strategies (fluctuating NAV).

4. The pool's list of eligible securities should be reviewed to determine compliance with the participating government's investment policy. Portfolio maturity restrictions and diversification policies should be evaluated to determine potential market and credit risks.

5. Portfolio pricing practices should be evaluated.

6. Custodial policies (e.g., delivery versus payment) should be reviewed.

7. The qualifications and experience of the portfolio manager, management team and/or investment adviser should be evaluated.

8. The earnings performance history should be studied and reviewed relative to other investment alternatives. On constant NAV LGIP funds, the current yield of the portfolio can be compared with competitive institutional money market funds, or overnight repurchase agreement rates. Standard & Poor's releases an index of LGIPs on a weekly basis that reports the average 7- and 30-day yields and average maturities of LGIPs holding its highest ratings (AAAm and AAm). Any pool with above-average yields or longer maturities should be further evaluated for risk.

9. Variable NAV LGIPs should be evaluated in relation to appropriate benchmarks.

10. Although ratings are not mandatory at this time, governments should seek LGIPs with the highest ratings, where possible.

11. Procedures for establishing an account, making deposits and withdrawals, and allocating interest earnings should be fully understood. There may be limits to the number of deposits and withdrawals in a month. There may also be dollar limits to deposits,

withdrawals and balances. Deposits or withdrawals may require advanced notification, especially if they are large. If so, investors should be aware of the deadlines.

12. Any additional services offered by an LGIP should be considered. For example: checking, wire transfers, issuing paying agent services, setting up multiple accounts for an entity, and arbitrage accounting for bond funds. 13. Government investors should confirm that an LGIP provides regular, detailed reporting to pool participants and follows generally accepted reporting standards.

References

- *Investing Public Funds,* Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998
- *An Elected Officials Guide to Investing*, Edition, M. Corinne Larson, GFOA, 1996
- *Standard & Poor's Guide to LGIPs*

IGFOA invites you to navigate the complexities of local government public pensions

Basics of Public Pension Management

Thursday, April 26   8:30–4:00 pm
NIU Naperville, 1120 East Diehl Road, Naperville, IL

Identify the public pension plans in Illinois

Differentiate between the types of public pension plans

Understand the roles staff, trustees, and service providers serve

Become familiar with the primary permissible investments

Identify relevant accounting and financial reporting standards

- Discuss the process involved in hiring managers and advisors

- Understand common disability issues affecting pension funds

- Learn about the Illinois Municipal Retirement Fund

- Gather additional resources for reference

Fee: IGFOA Members: $105   Non-members: $180*

**Registration for the Basic Public Pension Management Seminar entitles IGFOA members to a $45 registration discount for the IPP Institute on April 27*
Earn 6.5 CPE   Instructional Method:Group-Live
No prerequisites or advanced preparation

Illinois Public Pensions Institute

Friday, April 27   8:30–4:00 pm
NIU Naperville, 1120 East Diehl Road, Naperville, IL

- Explore the impacts of the 2006 Pension Protection Act

- Review the economic climate affecting pension funds

- Understand the nature of disabling injuries on public safety workers

- Discuss proposed legislation and impacts on local governments

- Learn how to evaluate deferred compensation programs

- Examine high-profile public pension fund crises and discuss ramifications for Illinois local government funds

- Discover how web sites can be a useful tool in managing public pension funds

- Discuss how to handle ethical dilemmas
- Learn about the Illinois Municipal Retirement Fund's new strategic direction
- Review proposed governmental accounting standards changes that will impact pension funds

Fee: IGFOA Members: $225 Non-members: $300*
**Register for the Basic Public Pension Management Seminar on Thursday, April 26 and receive a $45 discount when you register for the IPP Institute.*
Earn 6.5 CPE Instructional Method: Group-Live
No prerequisites or advanced preparation and register

Go to http://www.igfoa.org/seminars.html to learn more and register

"The pension fund, . . . I forgot where I buried it!"

© 2003 The New Yorker Collection from cartoonbank.com.
All Rights Reserved.