Gurtin Municipal Bond Management

Municipal Credit Research Report

Pension Reforms Are No Cure-All for Problematic Pension Plans

November 2015

Executive Summary

Illinois and Chicago's adverse court rulings this year exemplify how pension reform efforts are an often arduous and uncertain process that is fraught with judicial hurdles.

Given news of pension funds' widespread investment underperformance in fiscal year 2015, we anticipate calls for reform efforts will increase.

The success of reform efforts in each state is difficult to predict given a mishmash of legal protections across states.

Even when successful, pension reforms tend to gradually alter a pension system's trajectory. Most achievable reforms are unlikely to be immediate cure-alls. This is why we believe it is imperative to avoid obligors with pension plans that have passed what we deem to be an inflection point, and instead focus our clients' investments into obligors with manageable unfunded pension liabilities.

Illinois and Chicago's adverse court rulings this year exemplify how pension reform efforts are an often arduous and uncertain process that is fraught with judicial hurdles

The State of Illinois and City of Chicago again found their way back into the uncomfortably familiar position of center stage in the national discussion on public pensions earlier this year due to court rulings striking down both the State and City of Chicago's pension reforms in their entirety, and contributing to a downgrade of Chicago's bond rating to junk status by Moody's Investors Service.[1] This month, the Illinois Supreme Court is set to hear Chicago's appeal of the lower court ruling that overturned the City's pension reforms in July. The Chicago ruling came shortly after the Illinois Supreme Court declared the State's reforms unconstitutional,[2] and the judge that presided over the Chicago lawsuit drew heavily on the Supreme Court's ruling in issuing her opinion, citing its applicability to all government pensions in the State.[3] Given the Illinois Supreme Court's previous rulings on the ironclad nature of legal protections for public pensions in the State of Illinois, the Court is likely to continue to follow its own precedent and declare Chicago's reforms unconstitutional after it hears the City's appeal.

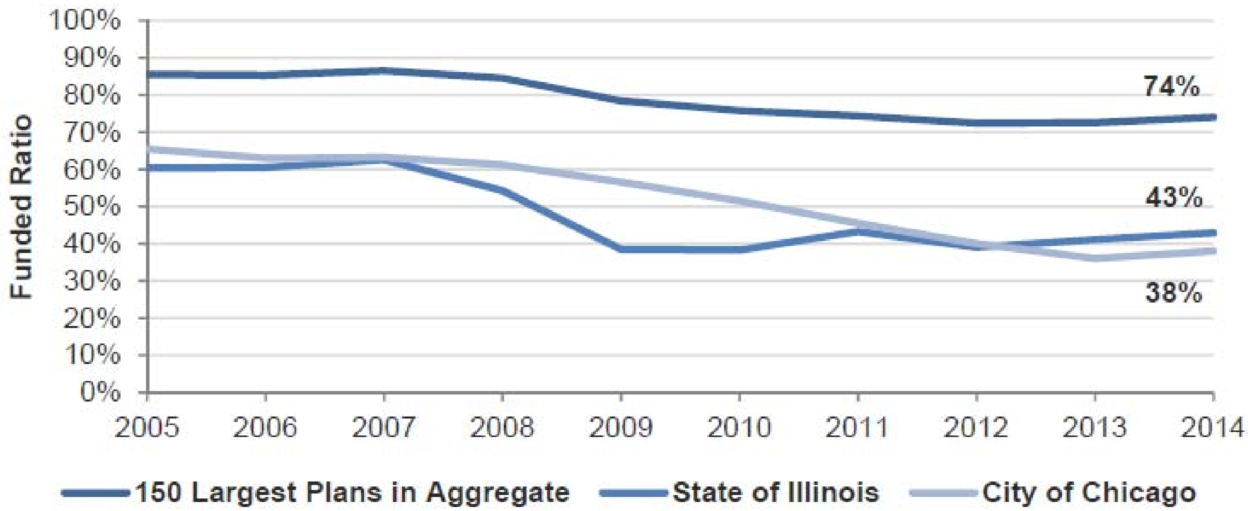
The State of Illinois' proposed pension reforms included reducing annual benefit increases, increasing the eligible retirement age, and capping final salaries used in benefit calculations, among other changes, for an expected $21.1 billion reduction in the State's unfunded liabilities as they stood at year-end fiscal 2014 (about 21% decline compared to what was calculated before the reforms).[4] Chicago attempted similar changes to two of its four pension plans, with an expected $2.4 billion decline in the unfunded liabilities of the two plans at fiscal year-end 2014, also about a 20% drop.[5]

Both Chicago and Illinois, along with the State of New Jersey, have become infamous outliers among state and local governments for their very weak pension funding levels and long histories of failing to make actuarial recommended payments to their pension plans. Their infamy is richly deserved; all three governments have pension funding levels well below the norm. In 2014, Chicago's four pension plans sat at a weak 38% funded level (100% is full funding).[6] The State of Illinois' pensions were funded at levels only slightly higher, 42.9%,[7] with New Jersey at a similar 42.5%.[8] This compares to an aggregate funded ratio of 74% for the nation's 150 largest pension plans.[9]

With such abysmally low funded levels, it is no surprise that states like Illinois and New Jersey have attempted to erase a portion of their pension liabilities through benefit reductions, and they are not alone in this attempt. Since the 2009 recession, pension reform has become de rigueur in most state legislatures, with nearly every state passing

[1] Moodys Investors Service. Moodys downgrades Chicago, IL to Ba1, affecting $8.9B of GO, sales, and motor fuel tax debt; outlook negative. May 12, 2015. Retrieved from http://www.moodys.com.
[2] In re Pension Reform Litigation (Doris Heaton et al. v. Pat Quinn, Governor, State of Illinois, et al.), 2015 IL 118585.
[3] Jones v. MEABF of Chicago. Case Nos. 14 CH 20027 and 20668. Cook County Cir. Ct. Opinion filed July 24, 2015.
[4] Letter from The Segal Company to the Illinois Commission on Government Forecasting and Accountability (ILGA). Segal Actuarial Cost study on P.A. 98-0599 (SB 1). March 21, 2014. Retrieved from http://cgfa.ilga.gov.
[5] Municipal Employees' Annuity and Benefit Fund of Chicago Actuarial Valuation and Review as of December 31, 2014. Laborers' and Retirement Board Employees' Annuity and Benefit Fund of Chicago Actuarial Valuation Report for the Year Ending December 31, 2014.
[6] City of Chicago Comprehensive Annual Financial Report (CAFR) for the Year Ended December 31, 2014.
[7] IL Commission on Government Forecasting and Accountability (ILGA). Special Pension Briefing. November 2014
[8] New Jersey Division of Pensions and Benefits. GASB 67 Summary Chart for 2014.
[9] Munnell, Alicia H. and Jean-Pierre Aubry. The Funding of State and Local Pensions: 2014-2018. Center for Retirement Research at Boston College. Number 45, June 2015. Retrieved from http://crr.bc.edu.

Figure 1. State of Illinois and City of Chicago Pension Plans Funded at Levels Significantly Below Average, 2005-2014



Source: Public Plans Database. Illinois Commission on Government Forecasting and Accountability. City of Chicago.[10]

some form of reform (with changes as small as reducing benefits for new hires only and as large as Ohio's sweeping reforms that changed the benefit formula, increased the retirement ages, and reduced cost of living adjustments). This trend has been driven in large part by significant investment losses during the recession, which drove up annual pension contribution costs. Given the large budget gaps many states continued to battle even after the recession, these growing pension costs were a natural target for cuts, and including pension reforms in a package of budget cuts can make other expenditure reductions more politically palatable by sending a message of shared sacrifice.

But the ability to pass and implement reforms is anything but certain given differing state by-state legal protections, and the deceptively simple nature of pension reform can be a distraction from attempting to solve pension problems through other means, such as fully funding the annual contribution recommended by actuaries. Illinois' reforms were passed in 2013, and it took a year and a half for litigation to weave through the courts before the reforms were ultimately declared unconstitutional. In the meantime, the State continued to make annual contributions below actuarial recommendations and its unfunded liabilities continued to grow. Each year of contributions below actuarial recommendations means the plans lose out on not only those contributions, but additional investment gains the extra contributions would have generated as well, thus compounding the problem.

[10] Public Plans Database. Retrieved from http://publicplans.data.org. ILGA. A Report on the Financial Condition of the Illinois Municipal, Chicago and Cook County Pension Funds of Illinois. October 2014. City of Chicago CAFR, 2014.

Given news of pension funds' widespread investment underperformance in fiscal year 2015, we anticipate calls for reform efforts will increase.

The allure of pension reform will likely continue to entice politicians, especially given lower than expected investment returns in fiscal 2015. Most plans calculate their funded levels and contribution schedules based on expected rates of return of between 7% and 8%, but for fiscal 2015, many plans have reported levels significantly below that, generally between 2% and 5%. The California Public Employees' Retirement System (CalPERS), the nation's largest public plan, reported a preliminary 2.4% return,[11] while the Florida Retirement System earned 3.67%.[12] If the pace of liability growth exceeds asset growth – which can happen due to demographic changes, cost of living adjustments, or an employer funding its annual pension contribution at levels below actuarial recommendations – than the lower investment returns will contribute to growth in unfunded liabilities and likely provide further support for pension reforms in states where political momentum has supported those efforts. Lower returns could also contribute to a recent trend of states lowering their rate of return targets, an outcome which also increases unfunded liabilities, since the expected rate of return is factored into the process of discounting unfunded liabilities to the present day.

The success of future reform efforts in each state is difficult to predict given a mishmash of legal protections across states.

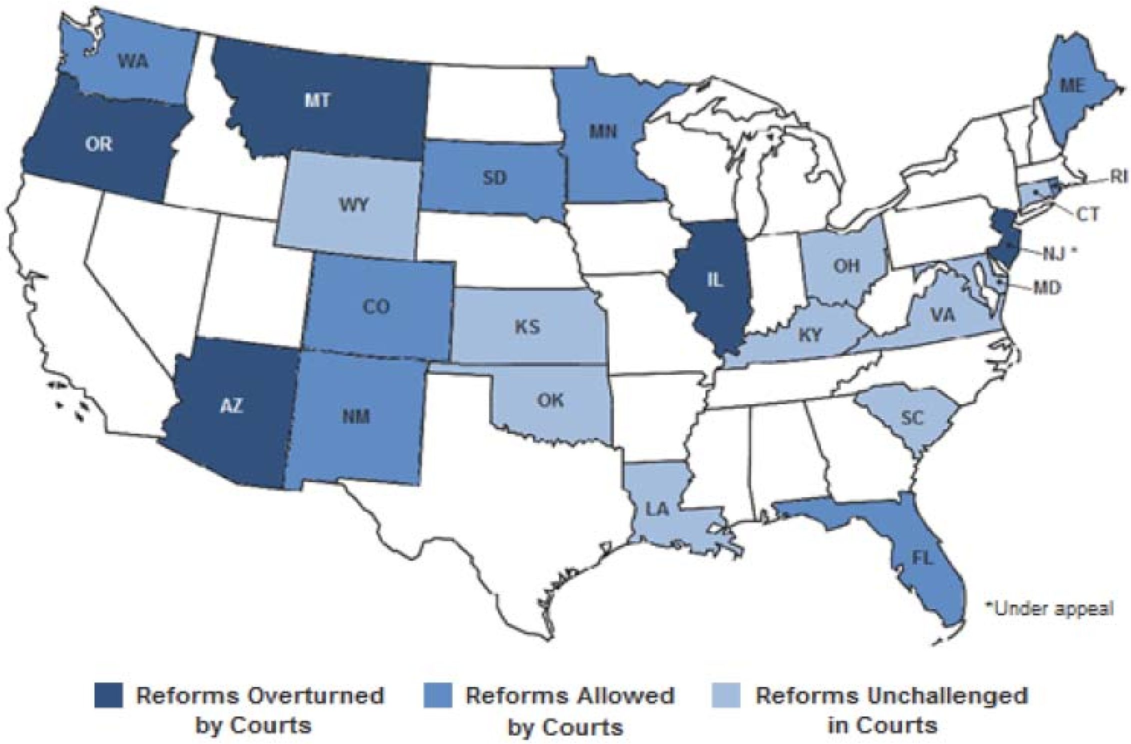
While state legislatures continue to explore new aspects of pension reform, whether those reforms will hold up in court is still murky territory in many states. Prior to the 2009 recession, pension legislation primarily focused on either enhancing retirement benefits or reducing benefits for new hires only, and thus the boundaries of allowable pension reform have remained relatively untested. Since then, state legislatures have attempted numerous types of reforms with a particular emphasis on cost of living adjustments (COLAs).

In many states, courts have separated COLAs from core pension benefits (a category that would include items like eligible retirement age and the formula used to calculate pension benefits), offering looser legal protections for COLAs. As Figure 2 shows, since 2009, 24 state legislatures have passed COLA reforms that would impact current employees and retirees (additional states have passed cuts that apply to new hires only).

Not all of those attempts held up to legal challenges – Illinois and Arizona saw their reforms overturned in their entirety, as did New Jersey, though the case remains on appeal. In Oregon and Montana, the courts ruled that reductions in current employee COLAs could only apply going forward, for benefits earned after the date of reform, and benefits earned to date were untouchable.

[11] CalPERS press release. CalPERS Reports Preliminary 2014-15 Fiscal Year Investment Returns. July 13, 2015.
[12] State of Florida press release. Florida Retirement System Pension Plan Posts Fiscal Year Returns. August 4, 2015.

Figure 2. Since 2009, 24 states attempted to reduce retiree Cost of Living Adjustments (COLAs) through pension legislation; 19 were successful



Sources: Munnell 2014, NASRA 2015.[13]

Legal protections for public pensions vary significantly from state to state

Why were Illinois and Arizona unable to reduce their COLA benefits unlike the 19 states that implemented COLA reforms? Pensions are governed by a patchwork of state specific protections that have evolved over time through case law and legislative actions and, therefore, vary considerably from state to state. While private pensions are regulated by the federal Employee Retirement Income Security Act (ERISA) of 1974, public pensions are exempt from these requirements and have no such unifying governance. This can lead to different outcomes for states that seemingly have similar legal protections.

For example, Colorado and Oregon both protect pensions via contract law, as shown in Figure 3 below. However, in 2014, the Colorado Supreme Court ruled that reductions in COLAs for both current employees and retirees were allowable because the COLA formula had been revised numerous times over the last forty years, and therefore no specific formula was guaranteed.[14] In contrast, in Oregon, the COLA

[13] Munnell, Alicia H., Jean-Pierre Aubry, and Mark Cafarelli. COLA Cuts in State/Local Pensions. Center for Retirement Research at Boston College. Number 38, May 2014. National Association of State Retirement Administrators (NASRA) Issue Brief: Cost-of-Living Adjustments. July 2015. Retrieved from http://www.nasra.org.

[14] Justus v. State of Colorado, 2014 CO 75 (2014)

formula had remained unchanged for the same time period, so the Oregon Supreme Court decided in 2015 that benefits earned before the date of reform were protected (so current retirees would not see their COLA cut) but changes could be made after the date of reform.[15]

Illinois is one of just seven states that have pension protection clauses explicitly written into their constitutions. This is the strongest form of protection for pensions. In the majority of the remaining states, including Colorado and Oregon, the courts have determined that pensions are protected via state or federal contract clauses, with nine other states using several different legal bases for protection, including declaring pensions the property of employees,[18] providing protection by promissory estoppel, which is the protection of a promise when no explicit contract exists, or deeming pensions a gratuity, with little formal protection.

Figure 3. States that protect both past and future benefit accruals and have a stronger legal basis for protections face the greatest difficulty in enacting pension reforms

Broadest protection → More narrow protection

Strongest legal basis ↓ Weakest

Pension Legal Basis	Type of Pension Benefit Accruals Protected[16]			
	Past and future employment	*Past and maybe future*	*Past only*	*None*
State Constitution	AK, IL, NY	AZ	HI, LA, MI	
Contract	AL, CA, GA, KS, MA, NE, NV, NH, ND, PA, TN, VT, WA, WV	CO, ID, MD, MS, MT, NJ, OR, RI, SC	AR, DE, FL, IA, KY, MO, NC, OK, SD, UT, VA	
Property	ME, WY	CT, NM, OH	WI	
Promissory Estoppel[a]	MN			
Gratuity				IN, TX

[a] Promissory estoppel is the protection of a promise even where no contract is in place.
Source: Table recreated from Munnell, 2012, which compiled data from multiple sources. Some minor modifications have been made to the original table.[17]

[15] Moro v. State of Oregon, 357 Or 167 (2015)
[16] Subject to change based on evolving case law. See endnote 18.
[17] Table recreated from Munnell, Alicia and Laura Quinby. Legal Constraints on Changes in State and Local Pensions. Center for Retirement Research at Boston College. Number 25, August 2012. The placement of each state under the type of protected benefit accruals is an evolving area, and we made some modifications to the original table. We moved Oregon and Montana based on Moro v. State of Oregon, 357 Or 167 (2015) and Byrne et al v State of Montana TRS, ADV-2013-738, MT 1st Dist. Ct. (2015).

[18] Legal protections under the "property" legal basis stem from the Takings Clauses in the 5th (…nor shall private property be taken for public use, without just compensation) and 14th (…nor shall any State deprive any person of life, liberty, or property, without due process of law) Amendments of the U.S. Constitution.

In addition to variations in the legal basis for pension protections, states differ on whether these protections apply only to benefits already earned for past service or can also be extended prospectively to future benefits for work an employee has not yet performed. In other words, are pension benefits locked in stone once granted and can never be reduced for that employee? If so, then these are the states, like Illinois, where it is seemingly impossible to change benefits for any current employees or retirees, and thus difficult to make much of a dent in pension liabilities through pension reforms. In contrast, in states where only past service is protected, such as Oregon, the legislature can pass a law that affects benefits earned after the date of reform, providing more leeway to change benefits granted to current employees (though current retirees are typically not affected).

Illinois' Ironclad Pension Protections are Rooted in the State's Lengthy History of Neglecting Pension Funding

In the case of Illinois, two overriding and unique themes clearly played a large role in both the Illinois Supreme Court's May 2015 decision to overturn Illinois' pension reforms, as well as the July 2015 lower court ruling to overturn Chicago's pension reforms. First, the State of Illinois has been chronically underfunding its pension since its inception in the 1940s. The Illinois Supreme Court opinion devotes four entire pages to describing the history of underfunding, citing reports from the Illinois Pension Laws Commission occurring biennially from 1947 to 1969 warning about pension underfunding.[19] Indeed, the pension protection clause itself was added to the state constitution in 1970 (45 years ago) during Illinois' Sixth Constitutional Convention specifically as a measure to protect pension benefits and attempt to compel the General Assembly to make its full contributions, which the Assembly had been neglecting.[20] The constitutional clause, however, did not have its desired effect. In 1970, the pension funds had just 41.8% of the assets needed to meet their liabilities, not too far off today's levels of 42.9%.[21]

The second theme that emerges from the Court's opinion is the weight placed on the pension protection clause being housed in the state constitution. While at first glance, this added protection may seem like a small distinction from contract law, as the Illinois Supreme Court explains, the added strength comes from the nature of a Constitution itself versus statutory legislation. The constitution is viewed as the voice of the people because it was ratified by the people; whereas, statutes are added by a particular General Assembly and can be modified by future General Assemblies. The people are "the ultimate sovereign" and through the Constitution, the people have imposed "limits on governmental action" to diminish or impair pensions, which essentially trumps any laws that

[19] In re Pension Reform Litigation, 2015 IL 118585, ¶ 11.
[20] Id, ¶ 13.
[21] Id, ¶ 12.

the General Assembly can pass that would impair pensions.[22]

Illinois' pension protection clause: "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Ill. Const. 1970, art. XIII, § 5.

Based on these two items, so central to the Illinois Supreme Court's opinion, short of amending the state constitution or negotiating an agreement directly with employees and retirees, it appears unlikely the Illinois Supreme Court would allow any challenged pension cuts within the state to stand. The Cook County Court's opinion heavily relied on the Illinois Supreme Court precedent when overturning Chicago's pension reforms. Chicago also has grappled with years of chronic underfunding and its pensions are protected under the same constitutional provision as the State. While Chicago believes its legal argument is different than the State's and its situation is different as the City's pensions are in more dire straits, we believe the situations are similar enough that it is likely that the Illinois Supreme Court will rule the same way when it considers Chicago's appeal of the Cook County court ruling.

[22] In re Pension Reform Litigation, 2015 IL 118585, ¶ 79.

States may start getting more creative with avenues for pursuing pension reform to evade legal constraints

With the inflexible nature of current legal protections in some states, policy leaders have begun to seek out new mechanisms for achieving pension reforms. In Illinois, Governor Rauner has discussed seeking a constitutional amendment to modify the pension protection clause and allow for changes to future benefits for current employees.[23] Changing the constitution would be an uphill battle to face, with a three-fifths majority needed in the General Assembly to place the amendment on the ballot for voters, and then passage by a majority of people voting in the election.

Meanwhile in California, which also has strong pension protections for both current employees and retirees, a group has submitted a voter initiative for the November 2016 ballot that would have a huge impact on the future of pension benefits in the state, though would not impact current unfunded liabilities. If approved, the measure would require that any government that wants to provide a defined benefit pension program to employees hired after January 1, 2019 would need to receive voter approval to continue to offer the benefit.[24] This effectively would close all defined benefit pensions in the state to new employees, unless voters choose to keep those plans open. While a few states have transitioned away from traditional pensions – notably Michigan closed its defined benefit plans for state employees in 1997 – the vast majority of states still maintain traditional defined benefit pensions.

[23] Erickson, Kurt. Rauner faces tough pensions fight; wants to amend Constitution. Quad-City Times. May 11, 2015. Retrieved from http://qctimes.com.
[24] California Legislative Analyst's Office. A.G. File No. 2015-033 (Review of Constitutional Initiative). Dated July 27, 2015. Retrieved from http://www.lao.ca.gov.

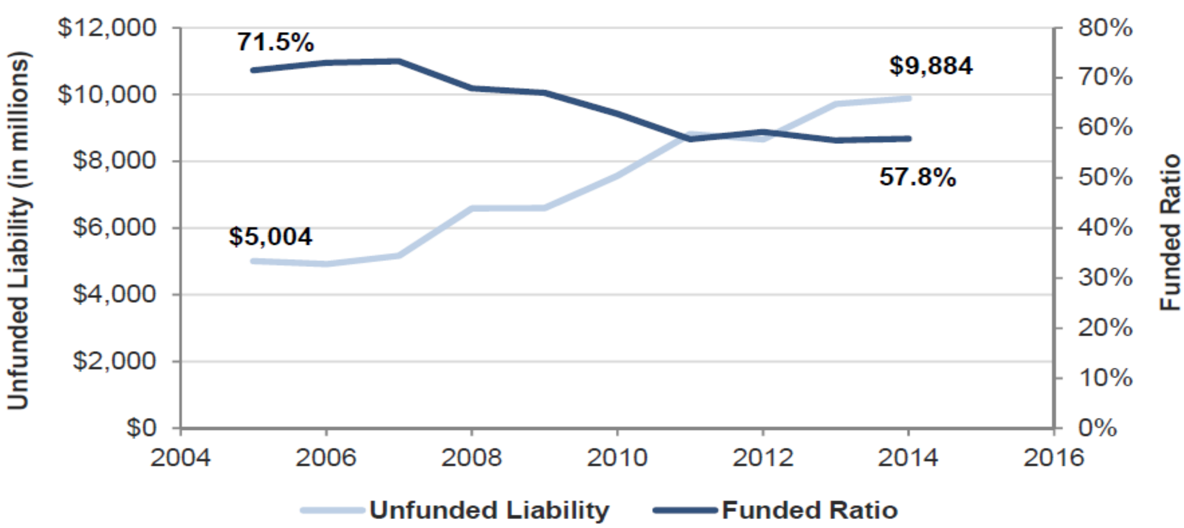
If successful, the initiative could have enormous ripple effects on other states, prompting other states to consider closing their plans, or encouraging similar voter initiatives in states that allow them, such as Washington or Oregon.

Even when successful, pension reform efforts tend to gradually alter a pension system's trajectory. Most achievable reforms are unlikely to be immediate cure-alls. This is why we believe it is imperative to avoid obligors with pension plans that have passed what we deem to be an inflection point, and instead focus our clients' investments into obligors with manageable unfunded pension liabilities.

Colorado was one of the first states to start tackling pension reform after the recession, with 2010 legislation not only capping COLAs but also changing final salary and age and service requirements for more recent employees. At the time, the reforms led to a substantial 34% estimated reduction in the State's unfunded liability. Despite this dramatic decline, pension reform has not been a cure-all. Since reforms were enacted, the unfunded liability has continued to grow and funded levels have fallen (Figure 4). While the reforms slowed the pace of growth in the unfunded liability, they were not sufficient by themselves to actually begin chipping away at it, largely because the State has continued to allow plan participants to fund their annual contributions below actuarial recommendations. In 2013, the State funded just 79% of its recommended contribution.[25]

For pension plans that are in relatively decent shape, there is still time to consider incremental adjustments system that has passed an inflection point, where it is

Figure 4. Colorado PERA's State Division Pension Funded Levels Have Worsened Despite 2010 Reforms



Source: Report on the Actuarial Valuation of the Public Employees' Retirement Association of Colorado as of 12/31/2014.

[25] Report on the Actuarial Valuation of the Public Employees' Retirement Association of Colorado as of 12/31/2014.

and test different options for reforms, perhaps to slow the pace of liability growth. However, for a pension difficult to see a realistic or practical set of solutions, reversing the pension system's trajectory is akin to turning around an oil tanker at sea. The substantial size of the liability and inertia against implementing changes will make any meaningful progress slow to see.

As an example of a City that has blown past the inflection point, if the City of Chicago had been fully funding its pension liabilities in 2014 based on actuarial recommendations, the City should have made a $1.7 billion contribution to its four pension plans,[26] representing a staggering 46% of the City's operating budget for its General and Pension Funds.
Instead, the City only contributed about one-fourth of this amount. In an effort to finally begin to face the City's pension woes head-on, Chicago Mayor Rahm Emanuel included a substantial $543 million property tax increase in the City's fiscal 2016 budget, with the increase phased in over four years and monies committed to pension funding.[27] Despite increasing existing property taxes over 50%, this still only puts the City at one-half of its actuarially-determined annual pension contribution, which means the unfunded liability will continue to grow. With such a large revenue increase still leaving a giant chasm in the City's ability to tackle its liabilities, it is difficult to see how the City will be able to return its funding levels to solid levels. Given this reality, it is no surprise that the City continues to look towards likely ill-fated reforms that have only a slight potential of reducing its liabilities.

While Illinois and Chicago are unquestionably outliers when it comes to pension funding, they are not alone, or the only government entities flirting with what we would deem to be an inflection point. However, many state and local governments have affordable unfunded pension liabilities and should not be painted with the same broad brush or get swept up into what we believe to be over-generalized pension panic. For this reason, we incorporate individual pension analysis into all of our credit reviews. In addition to reviewing trends in funded ratios and annual contributions over time, we also look at the obligor's actuarially-recommended contribution as a percentage of its budget and at the amount of outstanding unfunded liabilities in comparison to the overall budget size, among other metrics. We also recognize that pensions are but one part of an obligor's credit profile, so we review them in the context of an obligor's financial position, economic and demographic strengths and weaknesses, and overall debt profile as well. Even in the case of participation in a weaker (though not distressed) pension plan, an obligor may have other strong mitigating factors, such as a very strong financial position or significant financial flexibility that would enable the obligor to afford increased annual pension costs.

Conclusion

While we expect that state and local governments will continue to seek out alternate means to reduce unfunded pension liabilities as additional court decisions shape the boundaries of pension law, we will adhere to our belief that fundamental analysis of an obligor's holistic credit profile is the best means of determining potential signs of credit distress. Though

[26] This is the amount necessary to cover the cost of benefits accrued by all current employees for that year plus amortize the unfunded liability over a thirty year period, as determined by actuaries.
[27] City of Chicago 2016 Budget Overview. Mayor Rahm Emmanuel. Sept. 2015. Retrieved from
http://chicityclerk.com

we continue to closely watch pension reform efforts, we will not rely on any particular outcomes of court cases that could go through years of appeals. Even with ironclad pension protections and state Supreme Court rulings, states with distressed plans are likely to continue to grasp at straws and try their hands in the courts, and we expect pensions to continue to be a hot issue in the media. Pensions will play a significant role in the credit profiles of Illinois and Chicago, as well as other high-profile outliers such as New Jersey, for many years to come, keeping a national spotlight on pensions and their impact on state and local budgets. As the Illinois State Comptroller noted back in 1993 in testimony before the U.S. Congress on public pension funding, "Under-appropriated pension contributions are like unpaid credit card bills. The liability does not go away just because you choose not to pay the bill when it is due. You still owe the unpaid balance, plus interest."[28]

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[28] As quoted in In re Pension Reform Litigation, 2015 IL 118585, ¶ 18.

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