Six Simple Steps:
Reforming the Illinois State Universities Retirement System

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The ideas, proposals, and opinions expressed by the authors reflect their views and are not necessarily those of their institution.

The 97th General Assembly ended in January without passing a pension reform bill; leaving the fate of the pension systems in the hands of a new assembly. But solving the pension problem will not be any easier for this group of legislators. The unfunded liability of the state's five pension systems grew by over $10 billion since the 97th assembly started and now exceeds $97 billion; including a liability of approximately $19 billion for the State University Retirement System (SURS).

The task for the new assembly is clear: it must take decisive action this spring to pass a pension reform bill that creates a path to fiscal sustainability for the pension systems. As is well known, at the crux of the "pension crisis" is the state's failure over many decades to make required pension payments. That failure has come home to roost and the state is now required to follow a "pension ramp" to make additional payments to make up for that past underfunding. In addition, the state needs to pay off the pension obligation bonds (POB) issued over the past decade. These payments—at a time when Illinois' economy continues to be sluggish and the state owes billions of dollars in unpaid bills—are crowding out other state funding priorities and posing a major fiscal challenge.

What is required at this time is a path to a solution—a plan to stabilize the pension systems. Many legislators, groups and individuals—including us—have offered suggestions for reforming the pension systems. Here we build upon previous suggestions to propose six steps to set the State University Retirement System (SURS) on the path to fiscal sustainability while ensuring retirement security for participants and honoring the constitutional guarantee against reducing already accrued benefits.[1] Detailed discussion of the goals and principles motivating these proposals and more detailed discussion of some of the proposals presented here can be found in two papers published last year by the Institute of Government and Public Affairs at the University of Illinois.[2]

Our six-step proposal is designed to not only reduce cost and bring financial stability to the system but also improve the retirement program for universities and colleges. We also note at the outset that under our proposal, in the long-run (after existing unfunded liabilities have been paid off and after our proposed new "hybrid" system is fully in place), the state's obligation for ongoing pension funding will be *de minimis*. Over time, the direct employers—the

[1] While our proposal is structured in the context of SURS—to which all of us belong—our suggestions are relevant for the other pension systems as well.
[2] *Fiscal Sustainability and Retirement Security: A Reform Proposal for the Illinois State Universities Retirement System (SURS)*, Jeffrey Brown and Robert F. Rich, February 8, 2012; *A Time for Action: Reforming the State University Retirement System*, Jeffrey Brown, Steven Cunningham, Avijit Ghosh, and Scott Weisbenner, December 10, 2012.

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65 universities and colleges who are part of SURS—and their employees will accept the bulk of the funding burden, as institutions around the country already do. In return, each employer will have much more flexibility to adapt the basic retirement plan structure to meet its particular needs.

The steps in our proposal fall into three broad categories. In the first section of the document, we discuss steps to reduce the normal cost and liabilities of the Tier I defined benefit plan. Next, we focus on how the pension system should be funded. Our final step is to institute a "hybrid" system to replace the Tier II program for current employees. The inadequacies of the Tier II system put Illinois public universities at a serious disadvantage compared to their out-of-state peers and threaten the continued vitality of higher education in Illinois; no pension reform plan would be complete without addressing Tier II reform.

I. Reducing Costs and Liabilities

The first steps we propose would revise how the annual increase in the annuity paid to retirees and the effective rate of interest are calculated. These steps will reduce the normal cost of the Tier I pension program going forward and also reduce the current liabilities of the system.

Annual Annuity Increase

The provision of the current pension plan that has received the greatest attention is the automatic annual adjustment to the retirement annuity; typically referred to as the cost of living adjustment, or COLA. The current provision guarantees that the retirement annuity increases at a compounded rate of 3% annually. As we have noted elsewhere, when this provision was introduced in 1990 the state did not consider the full cost of providing this benefit and increased the benefit without adjusting employee contributions.[3] Given the high cost of this provision, it is not surprising that pension reform proposals have focused on inducing or forcing participants to accept a smaller increase. For example, some bills have suggested that retirees and current employees choose between a lower level of increase or forego access to state provided retiree health care. Other bills would limit the annual increase to the first $25,000 of the annuity.

There has been little discussion of the fact that as currently structured this benefit is not really a cost of living adjustment (COLA), since it is not linked to actual inflation rate. It is simply a guaranteed 3% increase in annuity irrespective of whether inflation is 1%, 7%, 10% or -1%. During times when inflation is low—as has been the case for some time now—retirees receive a windfall. On the other hand—generous as it may seem now—the COLA provision will not adequately protect the retiree's purchasing power during periods of high inflation. Consider, for instance, the period from 1973 to 1982: inflation was higher than 6% in nine of the 10 years during this period and it exceeded the 10% mark in four of those years. SURS retirees would have lost a significant portion of their purchasing power despite what now seems like a generous benefit provision.

The truth is that the current COLA provision offers no protection against high inflation—which is an essential feature of any good pension system. It is for this reason that we believe that annuity increases should be linked to some measure correlated with inflation. Linking COLA to inflation will also reduce the cost of providing the increases during periods of low inflation. Costs would increase when inflation is high; but the impact of this higher cost is mitigated by the fact that the state's tax base, and thus the state's tax revenue, rises more quickly when inflation is high. In our view, it would be constitutionally permissible to reduce the expected average future increase in exchange for the valuable insurance protection that individuals would receive during periods of high inflation.

STEP #1

The retirement annuity of current and future retirees will increase annually by one-half of the unadjusted percentage increase (but not less than zero) in the consumer price index-u in the previous twelve months, compounded upon the preceding year's annuity.

Effective Rate of Interest (ERI)

A little understood feature of the SURS pension system is the "Effective Rate of Interest" or ERI. The annual interest rate is not mandated by the constitution but is set each year by the SURS Board and the State Comptroller. As Brown and Rich had noted a year ago, the ERI, which is currently set at 7.5%, has historically shown very little variability.[4] Thus the ERI established by the SURS Board has included a significant risk-premium for what is essentially a risk-free return to the participants. This in essence represents a hidden subsidy in money purchase benefit calculations, portable plan refunds, purchase of service credits and refund of excess contributions.[5]

To eliminate such subsidies the ERI should be pegged to

[3] Brown, Cunningham, Ghosh and Weisbenner; op. cit.

[4] Brown and Rich, op.cit.

[5] Due to this subsidy the money purchase option is equivalent to a defined contribution plan in which participants are completely shielded from market risk yet paid the equivalent of risky market returns. Tier I participants who started employment after July 1, 2005 are not entitled to benefits under the money purchase formula.

the yield of long-term government bonds with a small premium added. This would be the commensurate return for an essentially risk-free asset. At the same time the change would significantly reduce both the accumulated liabilities of the system and the annual cost going forward. *It is important to note that the lower ERI has no effect on the defined benefit of 2.2 percent of income for each year of service to which Tier I participants are entitled.*

STEP #2

Going forward, Effective Rate of Interest (ERI) for all purposes, including the money purchase benefit formula, portable lump sum refunds, purchase of service credits and returns of excess contribution will be set to a value equivalent to 75 basis points above the interest paid by 30-year U.S. Treasury Bonds.

We also urge that other administrative rules such as those used to calculate survivor benefits when annuitizing money purchase benefits should be examined with an eye towards increasing transparency and comparability to market returns.

II. Sharing the Funding Liability

As we have stated earlier, at its core, the challenge to the pension problem is one of funding. Simply stated, the state seems to lack the wherewithal to make the required payments to the pension system to amortize past underfunding and fund the annual normal cost. The annual normal cost is currently shared by the employees and the state.[6] Consistent with a number of other proposals we suggest that the direct employers of SURS participants—public universities and colleges—should also contribute toward paying the normal cost. We also propose that Tier I employees increase their share of the normal cost. In exchange for accepting a larger share of the financial burden, employers and employees will receive the valuable right to enforce the state's pension funding obligation through the legal system.

The pension reform legislations debated by the 97th General Assembly included normal cost shifts as part of the solution. Although some have suggested eliminating this provision, we strongly believe that it should be retained. The provision will not only ease the state's financial burden but also appropriately align the incentives of employers to consider the cost of retirement benefits when making hiring and compensation decisions. As we have stated elsewhere, the employers need to have a "skin in the pension game."[7] By ignoring pension cost, employers underestimate the true cost of their hiring decisions. Cost transfer will also provide employees greater assurance that the required payments will be made in a timely manner. However, to avoid one-time budget shock for universities and colleges, the cost shift should be phased in gradually over a period of several years. In a letter addressed to the Governor and the legislative leaders, the Presidents and Chancellors of Illinois public universities agreed to a "limited" transfer of normal cost if the state maintained at least the current level of state appropriations to their institutions.[8]

To further ease the state's funding burden and in the spirit of shared sacrifice, we also propose that employee contributions to the plan be increased from the current 8% level to 10% of pensionable income over a two-year period (for Tier I participants in the traditional and portable plans only). A similar proposal has also been made by *"We Are One,"* a coalition of labor organizations in the state.[9] It should be recognized, however, that courts in some states have ruled against increased employee contributions without additional benefits, which is why this proposal must be specifically linked to the granting of appropriate legal rights to participants to hold the state accountable for its funding commitments.

An important aspect of pension reform is for the state to fill up the hole left by past underfunding by amortizing the unfunded liabilities (in addition to funding the state's share of the normal cost each year). To instill confidence in the pension system, the state must ensure a steady flow of funds in accordance with an agreed-upon schedule of payments. Some have suggested replacing the payment schedule passed by the legislators in 1995 with one that achieves 100% funding in 30 years. While this is a laudable goal, what is more important than the 30-year timeline is a steady stream of funding at an agreed upon rate and improving the funding ratio steadily.

Regular and full payments in accordance with an agreed upon payment schedule that steadily improves the funding ratio will raise confidence in the system even if it takes longer to achieve 100% funding. It is important, however, that the payment schedule is calculated based upon a straight-line amortization of the current unfunded liabilities using a closed amortization period. This would correct two important deficiencies of the payment schedule adopted in 1995. First, in contrast to the current schedule, which concentrates the bulk of the payments in the later years—especially post 2035—straight-line amortization would require equal payments each year. Second, in the closed amortization period method all the current unfunded accrued liability would be paid off in

[6] The annual normal cost is the actuarial estimate of the present value of the benefits accrued by participants each year.

[7] Brown, Cunningham, Ghosh and Weisbenner; op. cit.

[8] Letter dated May 3, 2012.

[9] http//www.weareoneillinois.org

full by the end of the agreed upon date. Together these features would increase confidence in the system and also reduce overall cost to the state in real terms. Specifically, we propose three funding related steps:

STEP #3

Universities and colleges will contribute up to 6.2% of the pension eligible payroll of their employees to fund the annual normal cost. The cost shift will be transitioned at a rate of 0.5% of pensionable pay per year for the first eleven years and 0.7% the twelfth year.

STEP #4

All employees enrolled in the Tier I defined benefit program will contribute an additional 2% of pay towards pension cost at a rate of an additional 0.5% of pay a year for the next four years. The additional employee contribution will not be included in the calculation of benefits under the Money Purchase Plan.

STEP #5

In return for the above cost-shifting, the state shall be required to amortize the current unfunded liabilities of SURS in accordance with a payment schedule that steadily improves the funding ratio and is calculated based on a straight line amortization of the current unfunded liabilities with a reasonable closed amortization period. Furthermore, the state shall be contractually obligated to contribute to the pension system each year the full amount of all its payment obligations. If the state fails to make full payment, the pension system or any of its members may take legal action to compel the state to make that payment.

III. Revised Retirement Plan for New Employees

No pension reform will be complete without rectifying the problems in the Tier II plan that went into effect on January 1, 2011. Thus, our proposed final step is to replace the current Tier II program with a "hybrid" plan that includes both defined benefit (DB) and defined contribution (DC) components. Integrating DB and DC components into a single retirement program helps to balance the pros and cons of each system individually. The DB component provides lifetime retirement security for participants, while the DC component, like 401(k) plans, allows participants more control over their retirement resources while controlling liabilities for the state and the employers.[10] Our proposed plan will allow universities and colleges to compete for talent and improve retirement security for their employees while still reducing the fiscal burden to the state.

STEP #6

Any new employee who becomes a member of SURS will participate in a hybrid plan comprising a defined benefit (DB) and an individual defined contribution (DC) plan. The current retirement plans—Tier II plan and Self-Managed Plan—will no longer be offered to new employees. Any employee who is currently a member of SURS can elect to terminate participation in their current plan and elect to have retirement benefits of future creditable service provided under the new retirement plan. The irrevocable choice must be made during the six-month period following the effective date of the new plan.

Below we present some of the salient features of the proposed plan. The features are designed to promote retirement security including a benefit that cannot be outlived, mandatory participation, shared financing, shared risks and flexibility for each university or college to tailor the program to the needs of its own work force.

The retirement plan for new employees will comprise both a defined benefit plan and a defined contribution plan; all members will be enrolled in both components of the plan. The plan will also be available to Tier I and Tier II members. If a member with accrued benefit under any existing plan elects to transfer to the new plan, all benefits earned under existing plan with respect to service completed prior to the transfer will be preserved. All creditable service already completed under the state pension system shall count for purposes of determining retirement eligibility and vesting under the new plan.

The features of the proposed "hybrid" plan include:

a. The defined benefit plan: Upon eligibility for retirement, members will receive 1.5 % of final average salary, up to the Social Security maximum taxable earnings level at that time ($113,700 in 2013) for each year of service credit earned while they are a member of this plan.

[10] For a more detailed discussion of the advantages of the hybrid system see Brown and Rich, op.cit. See also NASRA Issue Briefs: State Hybrid Retirement Plans I and II, November 2011 and August 2012, www.nasra.org/resources

b. Final average salary: "Final average salary" means the average monthly salary obtained by dividing the total salary of the participant during the 96 consecutive months of service within the last 120 months of service in which the total compensation was the highest by the number of months of service in that period. The final average salary of participants who have been a member of the system for less than 96 months means the average monthly salary during the entire period of employment. In all cases, only salary below the maximum earnings level specified in Item 'a' above will be included.

c. Self-managed (defined contribution) plan: Each member will also be automatically enrolled in a defined contribution plan established by the system, which shall offer members the opportunity to accumulate assets for retirement through a combination of member and employer contributions that may be invested in mutual funds, collective investment funds, or other investment products in a self-managed fund. The plan must be qualified under the Internal Revenue Services Act and contributions can be made up to the maximum amount allowed by the act. As noted below, this defined contribution plan will be funded by a mix of both mandatory and voluntary contributions from both employers and employees.

d. Payments: Each employee will be required to contribute 8% of his or her pensionable salary to the plan each year; based on the Social Security maximum taxable earnings level at the time. One-third of this amount shall be credited to the employee's self managed (DC) plan and the rest towards the cost of the defined benefit plan. The employee's contribution shall be deducted from the employee's salary and will be a condition of employment.

The state shall be responsible for the remaining portion of the normal cost of the defined benefit component of the plan. Consistent with normal cost shift described earlier (Step 3), the state's normal cost obligations will be transitioned to the universities and colleges at the same rate as that described before. In this case, however, we expect the state's obligations to be completely shifted to the direct employers at the end of the transition period.

In addition to funding the normal cost of the defined benefit portion as described above, universities and colleges will also make a mandatory annual contribution equal to 1% of total pensionable pay to the DC account of each employee.

e. Supplementary DC Contributions: In addition to the above funding, each university or college will have the flexibility of making additional employer/employee contributions to the DC plan. This could take the form of additional fixed or matching contributions by employers and voluntary contributions by employees. Employers will have the flexibility to vary the contribution amounts in order to optimize their human resource goals related to their own workforce recruitment and retention needs in a manner consistent with all applicable laws.

f. Vesting: Employee contributions to the plan, including the accrued rate of return attributable to contributions to the DC component, shall always be vested with the employee. State and university contributions to both components of the plan, including the accrued rate of return attributable to state and employer contributions to the DC component, shall be vested with the employee in the following manner: upon completing two years of service the member will be vested with 20% of the amount. For each additional year of service the member will be vested with an additional 20% of the amount. Members with six or more years of service will receive the total amount.

g. Cost of living adjustment: A member's defined benefit annuity will increase annually on the January 1 occurring either on or after the attainment of age 67 or the first anniversary of the annuity start date, whichever is later. Each annual increase shall be calculated as one-half the annual unadjusted percentage increase (but not less than zero) in the consumer price index-u, compounded upon the preceding year's annuity.

h. All other aspects of the program including parameters governing retirement eligibility, penalties for early retirement, disability payments and survivor benefits will be similar to the corresponding parameters governing the Tier II program.

IV. Impact of Proposals

Any meaningful pension reform proposal must improve the financial stability of the system while honoring the constitutional guarantee against reducing already accrued benefits. The proposal presented here achieves this goal. It reduces the normal cost and the current liabilities of the system, shifts the responsibility for paying a portion of the normal cost and then creates a legal obligation for the state to make timely payments to recover from past underfunding and fund the remaining normal cost.

Taken together the steps we propose will significantly reduce SURS' $19.3 billion unfunded liability as well as the annual cost of the pension system going forward. For example, changing the ERI going forward to 4% is likely to reduce SUR's unfunded liabilities by more than 5%. Linking the annual annuity increase to the inflation rate

will reduce the liability even further. Both steps will also reduce the annual normal cost of the pension system.

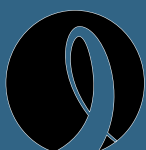
The transition of normal cost to universities and colleges in accordance with Step 3 will reduce the state's required normal cost payments to SURS between 2014 and 2045 by more than 70%. This is a conservative estimate since it does not include additional contributions from Tier I employees; nor does it consider the reduction in normal cost achieved by other the steps of our proposal. Finally, the hybrid plan is designed with an eye toward not increasing the cost to the state in the short term and over time transitioning cost to universities and colleges. It also allows each institution to design a retirement system that best suits its own needs. The plan will help Illinois public universities and colleges recruit and retain the talent they need.

Taken together as a package, the steps we propose will significantly reduce the state's funding obligation to SURS and allow the state to make timely payments to fulfill the remaining funding obligations. This will instill confidence in the system and sustain it for the long term.

V. A Concluding Note

A comprehensive pension reform proposal has eluded Illinois legislators for two years. But delay will not make the problem easier or make it go away. The package of reforms presented here offers a credible path to a fair, equitable and feasible pension reform. Now it is time for action. Each passing day makes the problem more challenging and threatens the continued excellence of higher education in Illinois that has taken generations to build. The long run vitality of the state of Illinois depends upon action now.

Step	Summary	Impact
1	A member's retirement annuity will increase annually by one-half the unadjusted percentage increase (but not less than zero) in the consumer price index-u	Reduces normal cost going forward Reduces unfunded liabilities
2	Effective Rate of Interest will be set to a value equivalent to 75 basis points above the interest paid by 30-year U.S. Treasury Bonds	Reduces normal cost going forward Reduces unfunded liabilities
3	Universities and colleges will contribute up to 6.2% of the pension eligible payroll of their employees to fund the annual normal cost. The cost shift will be transitioned over a 12-year period	Reduces normal cost payment obligations for the state
4	All employees enrolled in the Tier I defined benefit program will contribute an additional 2% of pay towards pension cost transitioned over a 4-year period	Reduces normal cost payment obligations for the state
5	The state shall be required to amortize the current unfunded liabilities of SURS in accordance with a payment schedule calculated based on a straight-line amortization of the current unfunded liabilities with a reasonable closed amortization period. If the state fails to make full payment, the pension system or any of its members may take legal action to compel the state to make that payment	Assures long term funding and amortization of unfunded liabilities
6	All new employees who become a member of SURS will participate in a hybrid plan comprising a defined benefit (DB) and an individual defined contribution (DC) plan	Reduces state normal cost payments by shifting costs to universities and colleges. Institutions gain flexibility to design system to fit their own needs



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