2013

FY2012 Cook Employees' and Officers' Annuity & Benefit Fund Actuarial Valuations

Truth in Numbers

The Cook County Pension Fund

Protecting Retirees, Protecting Taxpayers & Maintaining the Retirement Promise to County Employees

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Introduction

A well-funded retirement system provides financial stability to employees, their families and taxpayers. County employees play a critical role in keeping our communities safe, providing medical care, protecting our forest preserves, and administering the property tax process. The retirement package offered by Cook County helps to recruit and retain quality public servants. In order to ensure that the Cook County Pension Fund remains solvent and secure for retirees, does not require unaffordable tax increases and does not crowd out other important County services the system must be kept in good financial standing.

Since, 2006 the Cook County's Pension Fund has seen a 21.8% drop in funded status. The funded status is the amount of assets available to pay for promised pension benefits. The Cook County Pension Fund has a funded status of 53.5% thus will not have the money to pay for 46.5% of the currently promised benefits. In order to pay these costs the fund will need to either reduce benefits, increase contributions, find new revenue or a combination of all three.

This challenge is not unique to Cook County. The State of Illinois and the City of Chicago are both working to improve the funded status of their pension funds.

Cook County's pension system is established by the Illinois Legislature and governed by an independent board. Therefore, the President and Commissioners of the Cook County Board must work with the State Legislature to implement changes. The Cook County Pension Fund is funded through Cook County property taxes, thus the County is in need of its own solution to the pension solvency challenge. This report addresses the problems facing the Cook County Pension Fund and shows the impact of different options to fix the retirement benefit system for all current, retired and future employees.

This report will be organized around four key objectives:

2012 Average County Pension Payment was $35,795

- Explaining existing unfunded liability
- Diagnosing the key drivers of the structural pension deficit
- Understanding the implications of further inaction
- Providing a framework for solutions

A fair and realistic solution will involve input from all stakeholders and must begin by understanding the financial state of the fund and the level of benefits needed for a sustainable retirement. Changes to the County pension fund may affect retirees, all current employees, or future employees, none of whom participate in the social security system. For this reason and to continue to attract quality doctors, nurses, state's attorneys, law enforcement and all public servants; the County must provide a retirement benefit that is sustainable and dependable.

Cook County employees and the County as the employer have always made the pension contributions required by State Statute, 8.5% for employees and about 13% for the employer. These contributions cannot make up for 2008 investment losses and because increased life expectancy is increasing total payouts, the funded status is still decreasing. Taxpayers depend on vital services from the County and these must not be crowded out by large contributions required by the pension fund. The primary objective of this report is to build a common understanding of the pension fund and lay the groundwork for a path to retirement security.

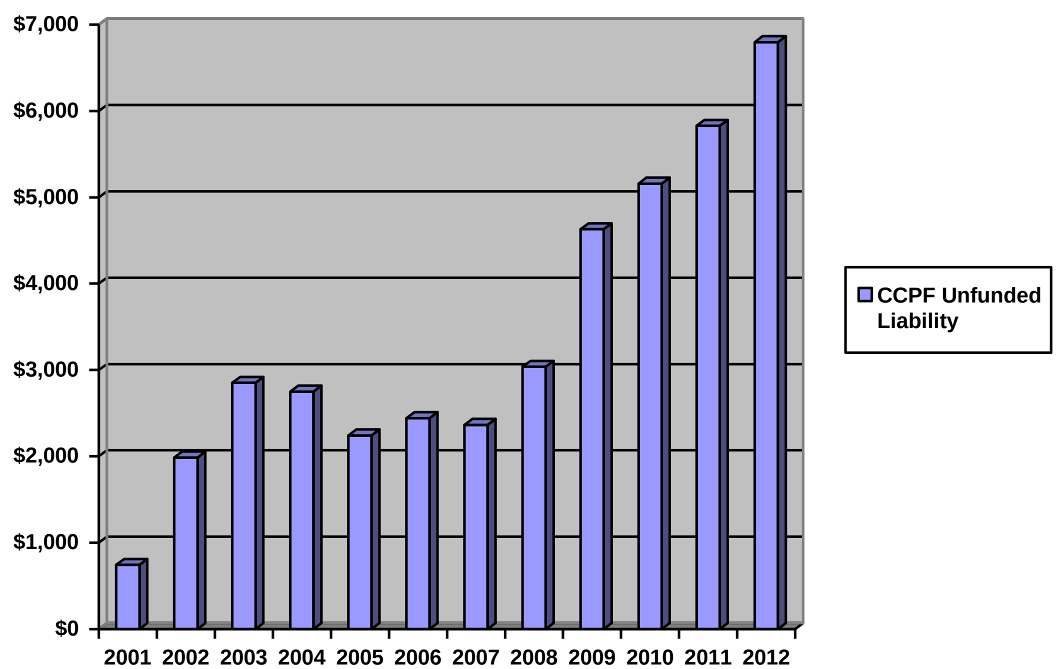
The Unfunded Liability

The unfunded liability is the difference between the total cost of promised pension benefits and the current value of the assets. Unfunded liability does not account for the future accrual of benefits.

The unfunded liability has increased by 915% since 2001

The 2012 Actuarial Report states that Cook County had total liabilities of $14,630,250,955 assets of $7,833,882,926 and a total unfunded liability of $6,796,368,029. In 2001 the unfunded liability was $742,713,420 and has since increased by almost 915%.

Cook County Pension Fund Unfunded Liability Growth 2001-2012 (Numbers in Millions)



Diagnosing the Key Drivers of the Structural Pension Deficit

It is important to understand the drivers of the growing gap between liabilities and assets over the last decade. The following are the key factors increasing the unfunded liability.

1. Funding the Benefits, but Ignoring the Unfunded Liability

The Actuarial Required Contribution (ARC) is the annual payment required to fund both promised benefits and address any unfunded liability. It is common for the ARC to be calculated to reach an 80% funded status. Every year this amount is calculated by an actuary and supplied to the County Pension Fund. Employers that contribute the ARC pay the difference between the ARC and the employee contribution. This causes a variable rate of payment for employers. Employers contribute more when the fund is under funded, or has a growing unfunded liability, and contribute less when fully funded. The County does not contribute the ARC, but rather a rate set by State Statute.

The current State Statute requires Cook County to contribute 1.54 multiplied by employee contributions two years prior and applied to the County's total payroll (approximately $1.5 Billion). Employees contribute 8.5% of salary annually resulting in a County contribution of approximately 13.09% for a total contribution towards employee retirement of 21.5%. In 2012 the employer contribution was $190.5 million.

It is important to note that the cost of benefits promised to County workers is around 20.97% of payroll and unlike other governments in Illinois; Cook County has never taken a pension holiday and has made this contribution every year since 1964. The contribution began to deviate from the ARC as the unfunded liability grew and the contribution remained the same.

2012 Average Cook County Retiree was 71 with 22 years of Service

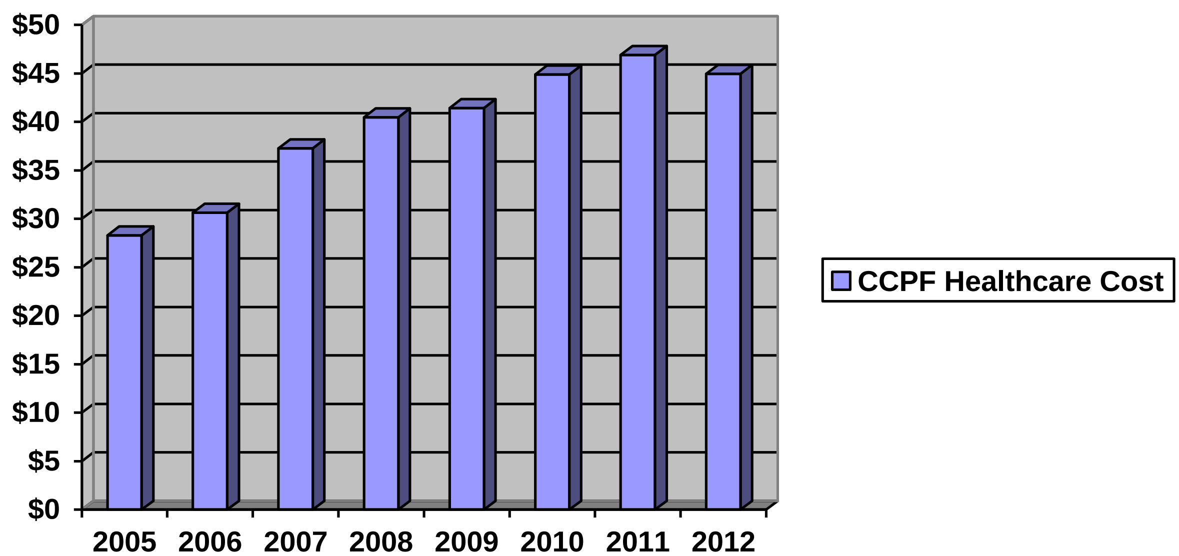
The 2012 County contribution to the pension fund was $190.5 million. This contribution was sufficient to meet the cost of the benefits promised, but did not address the unfunded liability. The actuarially required contribution that year would have been $719.8 million, a difference of $529.3 million.

The pension contribution paid by the County comes from the property tax levy, which has remained constant at $720 million since 1994. In order to meet the ARC last year the County would have had to levy $1.249 billion. This would have increased the County tax rate from .423% to .822% for 2012, a 58% increase.

2. Retiree Health Care Cost Increases

Beginning on December 1, 1991, the County split off healthcare for retirees into a separate plan and moved the cost and plan administration to the pension fund. Since then, healthcare is provided to Cook County retirees by the pension fund, not the County. The Cook County Pension Fund Board of Trustees has sole discretion in administering the healthcare plan and setting subsidy amounts. The pension fund provides retirees with a healthcare premium subsidy between 50-55%. In 2012, the fund paid $44,951,460 for retiree healthcare.

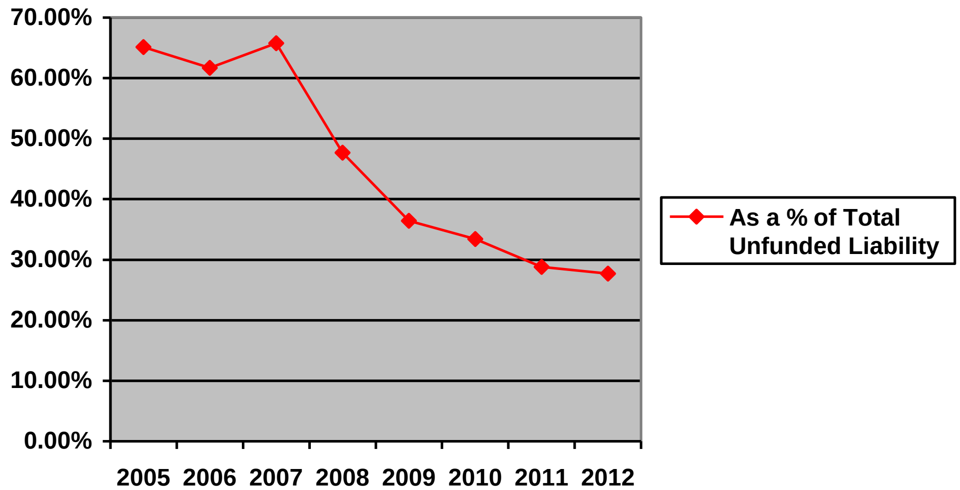
Cook County Pension Fund Retiree Healthcare Costs 2005-2012



The pension fund actuary estimates that in 2012 retiree healthcare had a liability of $1,845,609,132, or approximately 27% of all unfunded liabilities and no assets. Current Employees do not contribute towards their retiree healthcare.

In 2007 the unfunded retiree healthcare benefit accounted for over 65% of total unfunded liabilities to the pension fund. The graph below shows the percentage of the fund's unfunded liability attributable to retiree healthcare. The decrease in the ratio is due to underperforming investment returns.

Retiree Healthcare as a Percent of Unfunded Liabilities



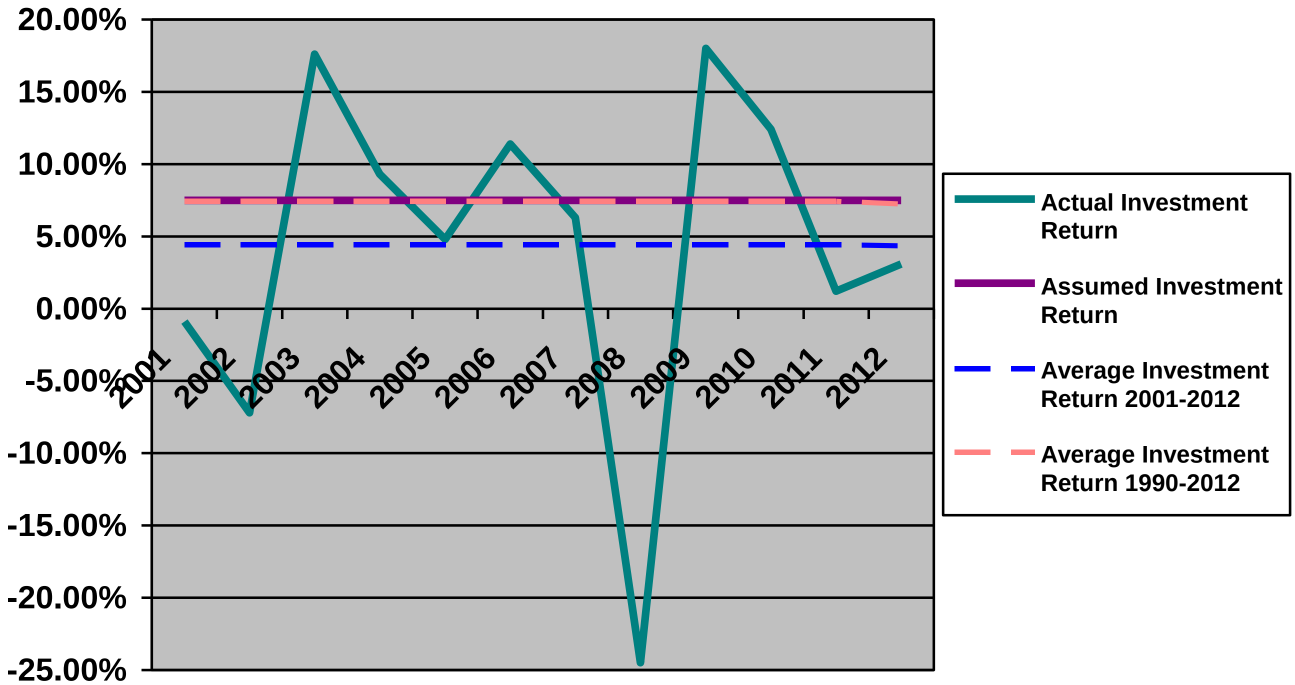
3. Lower then Assumed Investment Returns

The Cook County Pension Fund estimates future investment return rates to determine how much money needs to be contributed today to pay for retirement benefits in the future. The Cook County Pension Fund estimates a yearly investment return of 7.5%, this was reduced from 8.0% in 2005. Investment revenue usually comprises the majority of yearly pension fund revenue. In 2010 investment revenue returns were 70% of total fund revenue. However, in 2012 higher market value return of 12.5%, but lower actuarial return of 3.1% rate reduced investment returns to only 20% of total revenue.

Over the last five years, the average annual actuarial investment return rate 2.2%. Even before the 2008 market collapse the average return rate for years 2000-2007 was 5.76%. It is worth noting that over the last 23 years, the average annual investment return rate was 7.71%.

The Cook County Pension Fund is comprised of a nine member board. Four members are elected by current County employees, three are elected by current retirees and two are appointed by the County Treasurer and Comptroller.

Cook County Pension Fund Investment Returns 2001 – 2012



The financial crisis of 2008 decimated investment portfolios nationwide and the County Pension Fund was not spared. In 2008 the pension fund reported investment returns of negative 24.5% and lost $2,228,863,393. As a result unfunded pension liabilities increased over $1.5 billion between 2008 and 2009.

4. Early Retirement Incentives

The Illinois Legislature has created incentives for employees to withdraw from service before they would normally retire. The Illinois legislature offered early retirement opportunities in 1992, 1997, and 2002. Employees were given and additional 10% of their final average salary and allowed to withdraw before age 60 with no penalty, regardless of years of service.

The unfunded early retirement offers were used by the legislature to entice older employees to retire in order reduce salary costs to the governmental employer. This short term budget savings has had long term consequences on the fiscal health of pension funds.

The additional 10% benefit increase did not require additional employee contributions. In 2002 the legislature opened an early retirement period between Nov. 30, 2002 and March 31, 2003 for employees over age 50 with 20 years of service. The legislature offered employees an additional 10% of their final average salary to retire before March 31, 2003. Normally employees with less than 30 years of service cannot retire with a full pension benefit until age 60. 1,983 County employees took advantage of the early retirement offer and the County reduced payroll by $34 million dollars and eliminated 273 full time positions, however, it is estimated that the cost to the pension fund was far greater than any savings.

Early retirement offers negatively impacted funded status because increased benefits are not paid for. The total liability for the 2003 early retirement annuitants group was $1.43 billion – which includes the early retirement incentive. The impact of the early retirement incentives were not included in the actuary's report of 2003 and if these incentives are not banned in the future, the cost should be fully disclosed and paid for. The available information does reflect that in 2001 the funded status was 88.88% and by 2003 the pension funded status had declined to 67.52%. This 20% decrease is a combination of the early retirement offer and less than assumed investment returns.

5. People are Living Longer

People are living longer thus collecting pension benefits for a longer period of time. In 1990 a 60 year old person was expected to live for an additional 20.9 years. By 2007 a 60 year old person was expected to live 22.5 more years, an additional 1.6 years. While seemingly a small difference individually, the collective impact causes the fund to pay an additional 25,385 years of pension benefits for existing retirees only. The average pension benefit for a Cook County employee in 2011 was $35,795. Paying that benefit for an additional 1.6 years per retiree would cost $872 million. Cook County employees are expected to live until age 82 for males and 85 for females. With a retirement age of 60 a retiree will collect a pension for over 20 years, with survivors and dependents possibly collecting their benefit even further into the future.

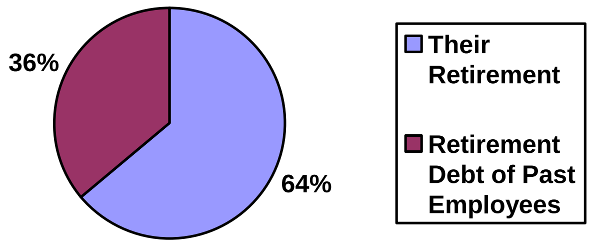
Implications of Inaction

The Cook County Pension Fund Actuary has determined that without any changes in the County pension benefit structure the fund will be insolvent by 2034. Insolvency means that the fund is depleted and cannot pay pension or retiree healthcare benefits. This would leave thousands of elder retirees without retirement income or healthcare coverage. This underscores the urgency of finding a sustainable and fair solution.

Without action the Cook County Pension Fund will be insolvent by 2034.

County employees hired after January 1, 2011 and all future County Employees are automatically enrolled in a Tier 2 pension plan resulting from the pension reform measure passed by the State Legislature in 2010. Tier 2 employees have a less expensive benefit with a higher retirement age, but equal contribution. While Tier 2 employees have a sustainable retirement benefit, the existing unfunded liabilities will still render the fund insolvent by 2034.

Tier II Pension Contribution Breakdown
Contribution That Funds Their Retirement Benefit v. Past Employee's Benefits



Cook County occasionally needs to issue bonds for capital. The growing pension fund liabilities have begun to impact general obligation bond ratings. In September 2011 Cook County's bond rating was downgraded by Fitch ratings from AA- from A. Fitch ratings cited the diminished financial flexibility of the County operating budget and the County's long term pension obligations. Cook County was also downgrade by Moody's Investors Service from Aa2 to Aa3 in June 2011. The State of Illinois had its bond rating lowered by Moody's Investor Service to A2 from A1. In its report Moody's cited the lack of State action on addressing the pension under-funding issue.

As the pension unfunded liability grows and the funded status decreases, Cook County could receive lower and lower bond ratings. Lower bond ratings will increase the interest the County pays on bonds and makes bond issuance more difficult.

It is possible that County Taxpayers would be responsible for any costs not covered by the pension fund. The total cost of benefits in 2034 is approximately $2 billion dollars, 66% of the current Cook County Budget.

Framework for Solutions

The deteriorating status of the pension fund is a concern to retirees, employees, elected officials, taxpayers and all residents who collectively benefit from public healthcare, the court and criminal justice system, forest preserves and real estate functions of the County. This challenge needs a solution that:

- Guarantees retirement security
- Attracts and retains quality employees
- Does not crowd out Cook County safety net services and functions
- Ensures taxes will not have to rise to a level that makes Cook County unaffordable for businesses and residents

The path forward must begin by defining a sustainable and dependable retirement security. Determining the level of benefit required to provide a stable and fair retirement will allow us to discuss benefit changes, contributions, revenues and the required legislative changes. Cook County pension reform should be:

- **Stable:** Creating a sustainable and affordable defined benefit structure.
- **Dependable:** Changes implemented today will guarantee retirement benefits for current and future retirees.
- **Self-correcting:** Eliminating the need for future reform by implementing a system that contains self-correcting triggers when funding levels fall.

All discussions should be conducted in a transparent and open forum. Data and proposals should be shared openly by everyone. Any proposed reform should contain the following:

1. **Reduce the Unfunded Liability**: This is the debt for past service. It is not possible to reduce this debt without making adjustments to the expectations of current workers or retirees. No reforms consider diminishing benefits already earned, but excluding retirees and current employees from pension reform legislation will significantly hinder the improvement of pension funded status. Additionally, excluding retirees will create an incentive for those eligible for retirement to leave the system before the effective date of legislation. 30% of Cook County employees are eligible to retire today. Besides the workplace disruption, this type of exodus would lock in the unfunded liability accrued for these active employees.

2. **Increase Pension Assets**: The current payment of employee and employer contributions will not reduce the existing unfunded liability. Additional contributions will have to be contributed to the system to pay down existing deficits. Increasing the employee contribution just 1% to 9.5% (and the corresponding employer contribution from 13.09% to 14.63%) would add an additional $35 million, $13 million from the employees and $22 million from the employer, to the system annually.

3. **Equitable and Reasonable Change**: There must be changes to the existing benefit structure that reduce long term liabilities.

    - **Cost of Living Adjustment (COLA):** Currently retirees receive a 3% compounding COLA after their first year of retirement. This benefit has the most significant impact on future liabilities. At this rate a retiree receiving a full pension benefit would earn a pension within 10 years that equaled their salary when they retired. Only reducing the COLA to a simple 3% or ½ CPI, whichever is lower, for retirees and current employees would keep the fund solvent until 2039, an additional 5 years. COLA’s ensure that retiree’s pensions match rising consumer costs, but they need to be aligned with the actual change in the price of consumer goods. Reducing the COLA for current employees would reduce the unfunded liability by approximately $750 million, reducing the COLA for retirees and current employees would reduce the unfunded liability by $1.5 billion the first year of implementation.

- **Retirement Age**: Given the increases in life expectancy, it is reasonable to assess the impact of increasing retirement age. County employees can retire up to 16 years before the current age of 66 for Social Security and Medicare.

- **Accrual Rate**: A key driver of the cost of any pension fund is the accrual rate. The calculation works as follows: The County's current accrual rate of 2.4% is multiplied by years of service, so that 30 years of service = 72% of final average salary. Other plans have lowered the accrual rates and layered other savings vehicles (401K, cash balance plans) on top.

- **Final Average Salary**: The current final average salary is the highest consecutive 4 years salary in the last 10 years. Increasing the final average salary to the highest consecutive 8 years in the last 10 years, or otherwise prohibiting a significant late career salary from spiking a person's pension not reflective of career earnings, is important for solvency and perceived fairness for taxpayers.

4. **Make Retiree Healthcare Guaranteed and Permanent**: Healthcare for retirees is not mandated by State Statute or the Illinois Constitution and is not protected by collective bargaining. While the pension fund has been progressive about managing costs, healthcare is the greatest cost worry of many retirees and insuring it would offset the reduction in COLA. This will also provide retirees certainty about the availability of healthcare between retirement and eligibility for Medicare.

5. **Intergenerational Fairness**: Newer employees and future employees are paying the same rates as older employees and retirees, but receiving a smaller benefit. For Tier 2 employees only 2/3 of their contributions goes towards their own retirement, the rest is used to pay the unfunded liability. New employees should not be left to shoulder the burden of current unfunded liabilities. Solutions to the fund should ensure a fair amount is being contributed for future benefits.

6. **Comprehensive and Self Correcting**: Reform proposals will address the currently accumulated debt, but should also ensure that this problem doesn't reappear in the future. Instituting down-side triggers when the funded status is below a certain level will stop costs from increasing when the funded status is unstable.

7. **Hybrid Plans and Portability**: Plans that combine defined contribution and defined benefit features should also be examined. Adding defined contribution plans to the benefit package would offer employees an additional source of pre-tax retirement savings. New features of defined contribution plans can limit investment options, restrict hardship withdrawals and encourage the use of annuities to reduce the risk and mirror the retirement income aspect of a defined benefit plan.

   This type of plan also allows participants to move their retirement balances when they change employment, also known as portability.

8. **Moratorium on Early Retirement**: In the past the Illinois legislature and Cook County have offered incentive programs to employees to retire early. These practices have proven excessively expensive and contribute greatly to the unfunded liability. The legislature should institute a moratorium on this fiscal disaster or require a defined "pay-for" to advance fund the plan.

Path to Retirement Security

Historically, debates about pensions have been confined to the Statehouse and editorial boards, where, heated as the debate becomes, it does not engage the person on the street or the rank and file. Pension discussions also develop in a way that is unnecessarily binary: pro-worker v. anti-union; taxpayer protector v. tax-and-spender. It is time to take a different approach to solving this problem and hold an open conversation of the key points: retirement security, budget solvency and fairness to all stakeholders.

It is important that elected representatives, workers and all residents of Cook County take a practical approach that recognizes the legal and constitutional constraints, but also offers different retirement options that are fair and sustainable.

A commitment to a stable retirement has been made to all public service workers and it must be honored, but, to do so will require some no-nonsense reforms and a willingness by all parties to talk openly and honestly about immediate and long term solutions.

Pension funds across the United States have come together and worked collaboratively to shore up their funding and improve the long term fiscal outlook of their governments. It is high time for Illinois and Cook County to do the same.

The precise solution to the Cook County pension fund will be the result of discussions and proposals from many different parties. The funded status has decreased over 30% in the last ten years and we do not have the time to wait on passing meaningful reform. Each year that passes increases the unfunded liability and makes future corrective action more difficult. Reforms must be implemented that improve fund assets, decrease the growth in liability costs and ensure fairness for retirees, all current employees, future employees, and taxpayers. Cook County has the opportunity to lead in solving this problem.

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