OFFICE OF THE SENATE PRESIDENT
STATE OF ILLINOIS

JOHN J. CULLERTON
SENATE PRESIDENT

327 STATE CAPITOL
SPRINGFIELD, ILLINOIS 62706
217-782-2728

November 15, 2012

Mr. Tyrone C. Fahner
President, Civic Committee and Commercial Club
Commercial Club of Chicago
21 South Clark Street, Suite 430I
Chicago, IL 60603-2006

Dear Mr. Fahner:

I read with great interest your recent public letter to your fellow club members with the Commercial Club as well as your letter to Governor Quinn. Because both letters generate more heat than light, I felt it necessary to respond, especially since much of your rhetoric was foreshadowed in our meeting in July and in your August 1 letter.

As an initial matter, the pension system is fixable and you acknowledged as much to the Associated Press shortly after you issued your letters. Also, President Cullerton has shown the leadership and political will to confront this task. Indeed, the Senate passed HB 1447 on a bipartisan roll call in May, which would result in significant pension savings to SERS and GARS.

As you explained it best on Chicago Tonight on June 5, pension reform (SB 1673) failed in the House because House Republican Leader Cross refused to support the provision shifting normal pension costs to local school districts, universities and community colleges. That legislation would not only stabilize the retirement system for both state employees and retirees, but also improve the state's fiscal position so it can provide key services to all its citizens and its position in the capital markets. This is the same legislation you testified in support of in May and described on Chicago Tonight as "fair and would solve the funding problem."

In addition, HB 1447 and SB 1673 would achieve these goals within a *constitutionally-permissible* framework. The constitutionality of our efforts is critical because the rating agencies have informed the Governor's Office of Management and Budget ("OMB") that they will only consider upgrading Illinois' credit rating if our efforts are upheld in court. As we have discussed and debated at length, the contractual framework embodied in these bills provides the only legally-viable means of achieving meaningful and lasting reform.

Per our discussion, SB 1673 is expected to reduce our FY 2011 $83 billion in unfunded pension liabilities by $11.2 billion to $17.8 billion (or by 13.5 percent to 21.4 percent). By comparison, the Commercial Club's *unconstitutional* "comprehensive reform" plan from last fall, Senate Bill 512 (Cross), was claimed to reduce the state's unfunded liabilities by $3 billion to $5 billion—virtually the same reduction HB 1447 achieves just for SERS which already passed the Senate.[1] Given this data, I am hard-pressed to understand why you claim that SB 1673 and HB 1447 provide "insufficient" or "token" savings.

Your claim is especially surprising since the rating agencies informed OMB long ago that the enactment of just HB 1447 (or its equivalent) would be a positive step and buttress our current credit outlook. Prior to the August Special Session, though, you said HB 1447 was "a great piece of politics, and beyond that it doesn't do anything useful." House and Senate Republican Leaders, in turn, later opposed *any* pension reform legislation during the Special Session. True to form, Standard and Poor lowered its credit rating for Illinois on August 30 because the legislature had not taken "meaningful action" on pension reform.

The Senate President greatly appreciates your support of the cost shift provision and agrees with your assessment in July that it is simply "not so" that the requirement will result in increases in local property taxes. As you said on Chicago Tonight in June, the state can no longer let "local people make promises and the state has to pay for them."

As we discussed, the state is currently expected to pay the five pension systems $309 billion over the next 30 years. SB 1673 will reduce the amounts paid over that period by $66 billion to $88 billion. This savings will keep state pension funding between 15 percent to 16 percent of general revenues through at least FY 2020, and cabin the "crowding out" effect you complain of—even with the sunset of the income tax increase on January 1, 2015. The cost shift will further mitigate the "crowding out" effect by making school districts, universities, and community college responsible for paying $27 billion to $29 billion over the next 30 years. The Club's plan, as you know, would have significantly *increased* state pension contributions beyond expected amounts in the short term, magnified the "crowding out" effect on the state budget, and thereby left *even less* money to fund essential governmental services.

As far as Moody's proposed adjustments to evaluating pension liabilities, Moody's has stated, despite your claim, that "[n]o state ratings changes are expected as a result of publishing our adjustments to state pension liabilities and contributions." This is so because, according to Moody's, "[s]erious state pension funding challenges have been known for some time, and this knowledge is reflected in a number of state downgrades and negative outlooks assigned in the last two years."

Moreover, Moody's notes that its proposed adjustments —including the 5.5 percent discount rate referenced in your letter to Club members—are *not* intended to be "a guide, standard or requirement for a state or local governments [sic] to fund these obligations," as your letter suggests. Please be aware that while using Moody's 5.5 percent discount rate will significantly inflate our current $83 billion in unfunded liabilities, that same discount rate will also significantly increase the expected reductions in unfunded liabilities achieved by HB 1447 and SB 1673. This is because the same discount rate *must* be applied to both evaluating our pension assets and liabilities as well as the impact of the reform legislation.

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[1] House Bill 1447 is expected to reduce SERS' current $20.4 billion in unfunded liabilities by $3.2 billion to $5.7 billion or by 15.7 percent to 27.9 percent according to data provided by the system's actuary as compiled by the Governor's Office of Budget and Management. House Bill 1447, which covers just SERS and GARS, would also reduce the amounts paid to these systems over next 30 years by $23 billion to $31 billion.

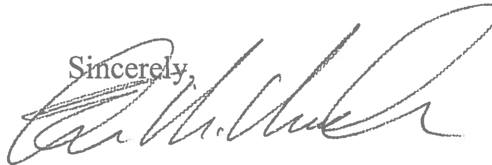
Simply put, if using Moody's 5.5 percent discount rate will hypothetically increase our $83 billion in unfunded liabilities to $120 billion, then the reduction in unfunded liabilities of $11.2 billion to $17.8 billion garnered under SB 1673 will also be much higher under Moody's discount rate because those reductions are premised on discount rates of 7 percent to 8 percent. As a result, whether a 5.5 percent or some other discount rate is used, SB 1673 should still achieve a 13.5 percent to 21.4 percent reduction of our current unfunded liabilities. I hope you have communicated this point to your members and not claimed that SB 1673 only brings unfunded liability reductions of $11.2 billion to $17.8 billion if you change your discount rate assumption. I also hope you communicated to your members that in September the Teachers Retirement System reduced its investment return assumption from 8.5 percent to 8 percent based on its actuary's recommendation.

With that said, I find it ironic that while Moody's wants public pension assets and liabilities valued at a 5.5 percent discount rate—the rate on high grade corporate bonds—at no time does Moody's advocate (or you for that matter) that the pension systems should exit the stock market and switch its investment strategy to just high grade corporate bonds or other riskless securities. As you know, no prudent investor would do that. If anything, Moody's "new pension math" seems geared toward simply inflating pension liabilities and admittedly nothing to do with changing pension system funding or investment behavior.

Finally, the retiree healthcare access offered as consideration in HB 1447 and SB 1673 will not, as you contend, "lock-in" "billions of dollars of unfunded retiree health care obligations." As you know and we discussed, the legislation offers access to a program of healthcare benefits that can be changed by the Department of Central Management Services annually to conform to state budgetary constraints. As a result, there is simply no merit to your claim.

Thank you again for your ideas and I look forward to continuing our discussions on this very important issue.

Sincerely,



Eric M. Madiar
Chief Legal Counsel & Parliamentarian