Report of Blue Ribbon Committee

City of Evanston

Fire and Police Pension Funds

October 24, 2008

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I. Introduction

Early in 2008, the Evanston City Council appointed a Blue Ribbon Pension Committee of interested Evanston citizens, to gain an understanding of the pension funding shortfalls in the Fire and Police Pension Funds. Committee members are independent and unaffiliated with Evanston government and their vendors.

Committee members include: Mark Metz (Chairman), Greg Beard, Gerald Gordon, Aleks Granchalek, Peter Morris, Sandra Shelton, Bill Testa, and Jim Young. City Staff attending meetings include: Finance Manager Martin Lyons, Steven Drazner and Phillip Baugher.

Mayor Morton hosted an introductory gathering on April 15, 2008 and the official work of the committee commenced April 23, 2008. Regular meetings were held about every 2 weeks and were conducted in compliance with the Open Meetings Act.

Our committee was provided the opportunity to fully explore this issue without limitations or constraints. The goals established by the committee include:

1. Understand how Evanston Fire and Police Pension Funds became underfunded by $145.8 mm.
2. Develop ideas for consideration by the City Council that would help to eliminate the underfunded liability by 2033 as required by current Illinois law.
3. Provide insight into the Fire and Police Pension Funds in Illinois.
4. Recommend best governmental financial practices for the future.

The Committee learned, as cited below, that all aspects of the Firefighters and Police Pension Funds are mandated by the Illinois Compiled Statutes (ILCS) and the Illinois Constitution:

- Each municipality shall establish and administer a firefighters' pension fund for the benefit of its firefighters and a police pension fund for the benefit of its police officers.

- Contributions by the firefighters and police officers are required. Additionally, the city shall levy annually a tax which will produce an amount which, when added to the deductions from the salaries or wages of firefighters and police officers and revenues available from other sources, will equal a sum sufficient to meet the annual actuarial requirements of the pension funds.

- The benefits shall not be diminished or impaired.

The City recently hired a new actuarial firm, Gabriel, Roeder, Smith & Company (GRS). GRS meets the requirements of the Illinois Pension Code for actuarial work of this nature.

They have a large list of clients similar to Evanston. They have reported that, as of March 1, 2007, the unfunded liability for the Fire and Police Pension Funds had grown to $140,195,204 with a very low “funded ratio” of 44.2% for the Fire Plan and 42.1% for the Police Plan. (The “funded ratio” is the ratio of the plans’ assets divided by the estimated amount the plans should hold now in order to pay all future benefits accrued up to that point in time). GRS more recently reported that, as of March 1, 2008, the total liability had increased to $145,792,613.

The fiscal health of Evanston is critical for our community’s long term viability. Managing the City’s operations in a fiscally responsible manner is critical to retaining current residents and commerce and for generating long run economic, social and cultural growth in our community.

We hope this report will provide insights into the pension funding shortfalls, and serve as a resource to enhance sound public policies which will benefit all members of the Evanston community.

Our committee extends it’s gratitude to all current, retired, and future firemen and police officers and their families. Their combined efforts and dedication keep Evanston safe.

II. Executive Summary

The Blue Ribbon Committee was convened by Mayor Morton to address the problem of growing unfunded actuarial liabilities in the fire and police pension plans. The goal of the committee is to provide the public, the Mayor, and the City Council a better understanding of how the problem evolved, what steps should be taken to address it, and what can be done to prevent it from happening again.

A. How Did We Get Here?

As will be shown in Table 1 on page 11 of this report, the City of Evanston Fire and Police Pension Funds did not become underfunded by $145 million overnight. The combined Unfunded Actuarial Accrued Liability (UAAL) was just over $48 million as of 3/1/1997 and grew to just under $98 Million as of 3/1/2006. By 3/1/2007 the amount had grown to over $140 million. The latest figures from 3/1/2008 report that the UAAL increased to $145.8 million.

Why such a large increase from 2006 to 2007? First, several key assumptions underlying fund assets and liabilities were not met during that plan year, causing an actuarial loss for the year. Second, and perhaps more importantly, GRS was hired to evaluate the pension funds during that year. GRS changed several key actuarial assumptions of the plans as well as the basic actuarial method since longer term results showed that actual experiences for Evanston's pension plans consistently differed with actuarial assumptions. As actuaries look into the future, the six assumptions having the greatest impact on their estimates of plan funding are:

1. Assumed rate of return on investments
2. Rate of increases in salaries
3. Mortality
4. Retirement age (age when employees will actually retire)
5. Disability (how many employees will become disabled)
6. Termination of service

GRS made assumptions for each of these factors that are more conservative than those made by the prior actuary (See Appendix A for details). Moreover, the actuarial method was changed to one that requires more contributions in the near term. While these changes in assumptions cannot definitively eliminate future deficits in the plan's ability to meet its payout obligations, the City's new actuary has increased the probability that the plans will be fully funded. Fully funded plans based on actuarially estimated annual payments insure that our fire and police personnel do not have cause for concern about their pensions. Similarly, fully funded plans insure that the City and its citizens do not have cause for concern about disruptive scrambles to fund or finance its pension obligations in the years ahead.

However, the downside to the recent changes in actuarial methods and assumptions and lower than expected returns on existing pension assets, is that amounts of required annual contributions have increased at a time when the City is already struggling with its budget. In fact, City staff, at the October 6, 2008 budget workshop, initially estimated the levy for Fire and Police Pension Funds will be $12.3mm for FY 2009-2010 compared with total City expenses last year of approximately $220mm.

Why did the actuary adopt more conservative assumptions, and why did plan funding levels erode even before the recent actuarial revisions? For a number of years, the plans earned less investment return than assumed; salaries increased more than was assumed; retirees lived longer than assumed; employees retired earlier than assumed; more employees became disabled than assumed; and fewer employees terminated service than assumed. It was a "perfect storm" of negative experiences for the plans. Add in a few benefit increases granted by the state legislature, and it all adds up to our current situation.

Was the old actuary wrong? Only time will tell. Actuaries use long economic cycles to make their assumptions. They do not often adjust their assumptions in response to year-to-year fluctuations in actual experience. Rather, actuarial assumptions are typically changed only following a careful assessment of ongoing and durable trends in experience. All of the assumptions used by the old actuary were within the broad range of "reasonable" as defined by industry standards.

The job of a pension plan actuary includes calculating how much money should be contributed each year so the plan will have enough funds to pay the benefits prescribed by the plan. The year-to-year stream of contributions should be as smooth and consistent as possible to avoid wreaking havoc on the budget of the employer. By changing to more conservative assumptions, the new actuary has increased the probability that the plan's payout obligation will be met over time from existing fund assets, and that the city and taxpayers will not encounter sudden surprises for additional revenue injections.

What about the City Manager, Finance Manager, City Council and Mayor? Were they "asleep at the switch"? These professional and elected officials were being told that the plans were well funded, the assumptions were reasonable, that the adverse trends would reverse and even out over time, resulting in improved funding status. Hindsight tells us that had more questions been asked, and more information been sought, City officials might have chosen to increase funding at an earlier time to mitigate the depth of the current crisis (See Table 1, page 11). Yet, we want to be clear that we found no evidence of any wrong doing or malfeasance.

We clearly assert that the "buck" starts and stops with the City Council and the Mayor. They are ultimately responsible for managing the City of Evanston and our current pension crisis. They are accountable and must take action to implement a plan to restore the health of the pension funds. In the past, and today, it is their responsibility to know these retirement plans and to take timely action to minimize any financial impact to the City.

B. What Should Be Done To Fix The Problem?

The City must make sure the funds are available when needed to pay benefits. The dedicated public servants covered by these plans have every right to expect that the accrued benefits are properly funded. The benefit levels are set by the State Legislature, not the City of Evanston. The scope of this report does not include any examination of the appropriateness of those benefits.

Current state statutes require that the Pension Plans must be fully funded by the year 2033. That gives Evanston about 24 years in which to meet the ongoing (normal) cost of benefits as they arise as well as amortize the unfunded liability. The City should make these contributions based upon reasonably conservative assumptions that are most likely to prevent the contributions from rising too sharply in the future. We should contribute enough now, to make sure we do not continue to put the problem off until a later date.

In this report, the committee recommends five avenues through which the City can raise funds to contribute to the plans:

1. Asset Sales/transfers/securitization
2. Additional revenue sources (Revenue Enhancements)
3. Alternative financing solutions
4. Budget cuts and efficiency changes in program delivery
5. Economic growth and development

The Committee strongly recommends that property tax increases should only be considered as a last resort, after all other sources of revenue and budget cuts have been exhausted.

C. What Else Can or Should Be Done?

The Illinois General Assembly controls the level of benefits and all other provisions of the Fire and Police Pension Plans. The committee recommends that the City should work through our elected state officials towards several reforms. These include but are not limited to:

1. Change the law that limits the scope of the plans' investments. This would allow the funds to follow a more conventional asset allocation and should, over time, result in improved investment returns.
2. Reform the way benefit increases are negotiated and granted. Currently, the General Assembly controls the benefits, but it is not responsible for funding them. That burden falls on the municipalities and ultimately on taxpayers. We should work towards a system wherein municipalities are full partners in these negotiations.
3. Give serious consideration to freezing the Defined Benefit Plans and starting Defined Contribution plans. This would be consistent with trends in the private sector.
4. Consider consolidating the investment functions and some administrative functions of the plans of all municipalities, except Chicago. This could result in great cost savings and other efficiencies.

City staff and elected officials should make some adjustments in order to more closely scrutinize the Pension Plans and monitor their financial performance.

1. Gather and distribute more information on pension costs tied to expansion of the employee base. For example, if an additional Fire Department position is under consideration, the full cost of that position must include all salary and all benefits, including projected pension costs for the long term.
2. A consulting actuary should be brought in every three years to review the work of the plans' actuaries and make recommendations where necessary.
3. City staff should participate in meetings and conferences, undertake training if needed, and confer with counterparts in municipalities statewide and elsewhere. The experiences of other cities with pension plan administration and experience can help the City of Evanston evaluate its pension situation and the performance of its actuary.
4. Should any authoritative and competing actuarial assessments of Evanston's fire and police pension funds be produced by an outside firm, agency or individual, the City and its actuary should strive to reconcile its own estimates with them.
5. Similarly, the City Council should continue its dialogue with citizens through intermittent reports on pension status, with public review and comment. With public and private financial matters alike, transparency and accountability are good governance practices.

D. Conclusion

The recent pension news for Evanston's residents is not good. Yet, Evanston has a number of options it can choose to address the current shortfall and to improve its pension management in the future. Finding the money to make the required contributions will be painful whether it comes from cutting other expenditures, increased revenues, or increased real estate taxes. Too often during crises and economic downturns, we become myopic and overly pessimistic. As Evanston rights its "financial ship", the community may be able to grow its tax base as businesses and households enhance their appraisal of the area's attractiveness to live and work. Surprises can also happen on the upside. However, we believe it would be irresponsible to merely hope for upside surprises for the pension situation and not take appropriate actions based on the current conditions.

III. Pension Fund Report

A. Evanston Fire and Police Pension Funds

The City of Evanston employs professional fire and police forces whose compensation includes a combination of salary and benefits. The pension portion of compensation benefits is the focus of this report.

Illinois Legislation, 40 ILCS 5, Articles 3 & 4, provides the legal framework for Fire and Police Pension Funds for all municipalities with fewer than 500,000 citizens (effectively every city in Illinois except Chicago). Under this law all firemen and police officers are provided a Defined Benefit Pension. A Defined Benefit Pension provides that upon retirement a defined dollar amount be paid to each beneficiary who has fulfilled his/her job requirements according to the pension agreement. Defined Benefit Plans differ from Defined Contribution Plans that have become standard practice among private sector employers. Under Defined Contribution Plans (e.g. 401k), a defined amount of money is paid into an investment plan each year. The accumulated assets are legally owned by the vested employees. In these plans, benefit payouts are determined by the levels of accumulated assets at the time of retirement, not on pre-determined benefit formulas.

There are tradeoffs between these types of plans. The major difference in the plan types is who bears the risk of underperformance of pension plan savings or assets. In Defined Benefit Plans, employees bear little risk in most situations as long as the sponsoring community remains financially solvent. Insolvency is a rare occurrence. In contrast, Defined Contribution Plans result in employees receiving fixed contributions to the plan and nothing more. If pension assets do not perform well, the employer bears no further financial liability for pension payouts.

A major consideration of the current Defined Benefit Plans for Fire and Police personnel, then, is that the City of Evanston and its citizens have a legally binding financial obligation to pay for the defined benefit pension liabilities as set forth under existing state statutes. In order to fund these liabilities and avoid sudden and dramatic disruptions to its finances when retirements take place, the City is required by law to make annual contributions to the pension funds.

Annual required contributions (ARC) have two parts. First, the normal cost funds the pension benefits for the current year's fire and police services provided to the community. Second, pension contributions also pay part of the accumulated pension obligations from past fire and police services. Past pension obligations were not fully funded because either (1) pension assets performed more poorly than expected (2) past pension contributions were not made on a timely basis (3) other expected retirement experiences deviated from actuarial assumptions or (4) benefits changed.

A separate Board of Trustees oversees the Fire Pension Fund and the Police Pension Fund. There are five members on each board, two of which are appointed by the Mayor of Evanston. The other three members on each board are associated with the Firemen and Policemen. The Pension Board of Trustees hires an investment advisor and oversees the pension plan assets and administers its payouts.

In the fiscal year ending March 1, 2008, the Fire Department employed 113 active firefighters and their pension plan covered 232 people. The total pension liability was $111.7 million and plan assets totaled $47.0 million, resulting in an unfunded liability for the Fire Pension Plan of $64.7 million. Firemen contribute 9.455% of their annual salary to their pension plan.

In the fiscal year ending March 1, 2008, the Police Department employed 161 active officers and their pension plan covered 326 people. The total pension liability was $145.5 million and plan assets totaled $64.4 million, resulting in an unfunded liability for the Police Pension Plan of $81.1 million. Police officers contribute 9.91% of their annual salary to their pension plan.

The total unfunded liability for both the Fire and Police Funds at March 1, 2008 is $145.8 million. To put this in context, the unfunded liability is about $1,921 per Evanston resident, or $4,490 per Evanston household. Census estimates from 2007 indicate there are 75,905 residents and 32,471 households.

B. Understanding How the Unfunded Liability Became $145 Million

The unfunded liability is the difference between the pension fund assets and the pension fund liabilities. (The official terminology is Actuarially Accrued Assets and Liabilities – the difference between Assets and Liabilities is a pension fund surplus if the figure is positive and a pension fund deficit i.e. unfunded pension fund liability if the figure is negative). A fully funded pension plan generally means that, if all operations of fire and police were to cease today, the accumulated assets of the pension plan would be able to pay out the accumulated retirement benefits to employees at the time of eligible retirement age, without further contributions by the City or by employees for services rendered up to that point in time.

This is a balance sheet issue, and as such, the numbers referenced are at a point in time. That is, the unfunded liability at March 1, 2007 was about $140mm and the unfunded liability increased to just over $145mm as of March 1, 2008.

The liability will change over time depending on how the Actual Experience of the pension fund plan performs relative to its Assumptions. This is an income statement issue, and the results are generated over the course of the year.

In practice, a professional actuary, in consultation with the City, provides a set of assumptions and a modeling framework with which to plan required contributions in order to fund future pension benefits. In a perfect world where expectations are met exactly, there would be no deviations from the anticipated liabilities and assets, positively or negatively. However, in practice, actual experiences do differ from expectations. Under a well structured plan with conservative assumptions, the deviations tend to be both negative and positive over time. The transitory shortfalls and surpluses should revert to the mean, and result in little change over time to the long run average net liability. However, with overly aggressive assumptions, the probability increases that the actual experience will underperform expectations on an ongoing basis, resulting in a growing unfunded pension liability. Such situations can require unexpected infusions of contributions, and can be accompanied by chaotic fiscal situations to municipal budgets and interruptions to service programs of all types. The committee recognizes that near term, cyclical issues will cause deviations, but for reference purposes, we are considering longer run and structural issues.

A reasonable person would conclude that pension fund issues are not a recent occurrence. A Google search on “unfunded pension funds” produces numerous articles on this topic. The unfunded liability is not a new phenomenon for Evanston; it started growing in the 1990’s and continued into the current decade. Table 1 on page 10 shows the steadily increasing unfunded liability.

Table 1

Evolution of Unfunded Liability - March 1, 1997 - March 1, 2008

March 1st Year		Unfunded Liability Fire	Police	Total
1997	(1)	$17,819,909	$30,380,488	$48,200,397
1998	(1)	16,990,637	29,445,021	46,435,658
1999	(1)	18,262,680	29,702,720	47,965,400
2000	(1)	18,329,178	33,014,210	51,343,388
2001	(1)	21,052,488	36,649,235	57,701,723
2002	(1)	24,145,261	40,265,143	64,410,404
2003	(1)	29,308,210	49,773,748	79,081,958
2004	(1)	37,921,862	47,354,143	85,276,005
2005	(1)	40,431,597	51,156,780	91,588,377
2006	(1)	43,759,643	54,048,027	97,807,670
2007	(1)	44,471,000	54,675,000	99,146,000
2007	(2)	62,619,556	77,575,648	140,195,204
2008	(2)	64,689,319	81,103,294	145,792,613

(1) March 1, 1997 - March 1, 2007 data based on assumptions from prior actuary, Ted Windsor.

(2) March 1, 2007 and 2008 data based on assumptions from current actuary, GRS.

See Appendix A for a reconciliation between the prior and current actuary.

Source: City of Evanston 2007 Comprehensive Annual Financial Report, page 86 and GRS.

Some of the factors that caused this liability to grow are:

1. The rate of return earned on pension assets was generally less than the assumed rate of return (recall that the stock market peaked in 2000; Dow Jones on January 14, 2000 and the NASDAQ on March 10, 2000).
2. Pension benefits were enhanced by state statutes.
3. Ongoing pension payouts proved greater than those assumed by the plans' actuarial assumptions.
4. The City changed actuaries from Ted Windsor & Associates to Gabriel, Roeder, Smith & Company resulting in recognition of additional unfunded liability, which rose from $100 mm to $140mm as of March 1, 2007.

See Appendix A and B for more details on Actuarial Changes, Methodology, and Assumptions.

Table 2 shows the annual estimated cash contributions Evanston taxpayers will be required to make in order to fully fund both pension funds by 2033. It should be noted that these figures are estimates. Schedules of anticipated contributions will likely change(up or down) as the plan's assumptions are adjusted in coming years to more accurately reflect trends in actual plan experiences as they unfold. The data in Table 2 are based upon March 1, 2007 information which showed the pension funds were unfunded by $140mm. March 1, 2008 data show the plans are underfunded by $145mm.

Table 2

Annual Cost of Funding
Evanston Fire and Police Pension Plans

Tax Year	Fiscal Year		Annual Cash Contribution
2006	2007	$	8,017,213
2007	2008	$	12,146,658
2008	2009	$	12,576,891
2009	2010	$	13,029,699
2010	2011	$	13,488,577
2011	2012	$	13,973,420
2012	2013	$	14,444,742
2013	2014	$	14,980,418
2014	2015	$	15,507,561
2015	2016	$	16,069,919
2016	2017	$	16,654,585
2017	2018	$	17,239,180
2018	2019	$	17,860,749
2019	2020	$	18,500,568
2020	2021	$	19,160,724
2021	2022	$	19,840,044
2022	2023	$	20,534,906
2023	2024	$	21,271,680
2024	2025	$	22,023,848
2025	2026	$	22,765,744
2026	2027	$	23,618,850
2027	2028	$	24,408,405
2028	2029	$	25,294,738
2029	2030	$	26,204,508
2030	2031	$	27,163,308
2031	2032	$	28,195,011
2032	2033	$	29,320,170
2033	2034	$	16,004,448
	Total =	$	530,296,566

Source: Gabriel, Roeder, Smith & Company.

A number of questions arise as to why action was not taken earlier to address this growing underfunded pension issue. Oversight of the pension funds is a responsibility of the City's Finance Manager and the City Manager. The Aldermen and Mayor ultimately oversee all operations for the City. We would also note that the Police Fund Board of Trustees sued Evanston in 1987 for failure to adequately fund the Police Pension Plan. A decision was rendered in 2005. While the court found in favor of the City, the underlying issues that gave rise to the lawsuit seemed to go largely unheeded by the City Council.

Accordingly, it is our recommendation that City of Evanston officials implement appropriate policies and procedures to monitor pension related budget items and intervene at an earlier time to take corrective actions.

At this time, our community has legal and moral obligations to provide for the pensions earned by all the firemen and policemen, and every incentive to do so from the standpoint of sound financial management and budgeting practice.

C. Solutions to Consider

Under current Illinois Legislation, there are a limited number of options to consider for reducing the unfunded liability. These options can be categorized into five areas.

1. Asset Sales/Transfers/Securitization
2. Incremental Revenue Sources (Revenue Enhancements)
3. Alternative Financing Solutions
4. Budget Cuts and efficiency changes in program delivery
5. Economic growth and development

While we will review solutions to consider, this list is not meant to be exhaustive.

1. Asset Sales / Transfers/Securitizations
    a) Transfer funds from the General Fund to the Pension Funds – in the current budget, $4mm has been transferred. City Council should analyze the appropriate cash balances maintained and analyze the cost/benefit of lower cash balances and increasing a line of credit at a bank (current money market returns are just over 2% while our assumed rate of return for pension assets is 7.25%).
    b) Real Estate Sales/Lease/Securitizations – does the city own excess real estate (e.g. parking lots/garages)that can be sold, leased, or securitized at some point with the proceeds used to reduce the outstanding liability?
    c) Enterprise assets can be sold or long term concession contracts can bring up-front payments.
    d) Facility naming rights can be sold or leased.

e) Find a way to reduce the lag time (currently about two years) between each plan year and the time at which funding for the corresponding year is deposited.
This will result in potential investment earnings that could, over time, significantly
reduce required contributions.

2. Incremental Revenue Sources

a) Not-for-profit, charitable, and religious organizations are typically exempt from property taxation and several other taxes, though they use or benefit from municipal services including fire and police. Since the time, that these exemptions were granted, municipal financial situations and the social contracts with their citizenry have evolved and/or been modified. Thus, in Evanston, such concessions should be reviewed and if warranted, tax exemption should be eliminated, or user fees for public services used should be imposed.

Conduct analysis for services consumed by each major not-for-profit entity, including hospitals, educational institutions, churches, retirement homes and others.

b) Other user fees/revenue sources, e.g. parking, enterprise receipts, sanitation, inspection, etc.

c) Taxes – Last Resort.

3. Alternative Financing Solutions

Pension obligation bonds (POBs) have received significant media attention over the last several years due to the increasing numbers of underfunded pension obligations at state and municipal levels. However, given minimal spreads between the cost of funds and the expected rate of return, the committee would not presently recommend utilizing pension obligation bonds as a means to reduce the unfunded liability. A more detailed analysis of the potential benefits and risks of POBs is included in Appendix C.

4. Budget Cuts and efficiency reorganization

a) The budget defines expenditures for the upcoming fiscal year. Former City Manager, Julia Carroll, gave City Council a list of items to consider cutting. In addition, we suggest changing the budgeting process from the current incremental approach to new zero based budgeting. Zero based budgeting requires reevaluating each program every year to justify its expenditures.

b) Reductions in current and/or future growth of basic municipal services provided to the community.

c) Can municipal operations be privatized or outsourced, and thereby be delivered to citizens at lower costs? These items might include sanitation, health and social services, and revenue collection.

d) What government reorganization might be contemplated? Should library and/or park services be provided and delivered by a special service/district with taxing authority rather than through city management? The recent wholesale retirement of senior management might make such changes less disruptive than otherwise.

5. Economic Development

As a result of recent very successful economic development efforts, the City has experienced a large influx of high rise apartment buildings. These buildings expand the taxpayer base, but also put greater demands on fire and police services. Economic development should now be directed towards acquiring more business, office, industrial, and retail services, which may provide increases in revenue to the City that is proportionately higher than the increase in cost of services.

Conclusion: The options mentioned above will present difficult decisions. Reviewing the priorities of our community will be necessary to determine which options should be pursued.

D. Longer Term Issues – External Challenges and Constraints

The current pension fund liability is the result of prior services rendered by firemen and policemen. Illinois legislation defines the legal framework for fire and police pension plans. However, in the long run, we as a community and and as a state should consider whether the current structure is in the best long term interests of all constituents. To the extent possible and appropriate, the City should cooperatively work with state legislators, other municipal groups, and other groups to change external constraints.

Issues to consider may include:

1. Current Illinois Legislation restricts investment options. Restrictions such as an effective maximum 45% equity allocation, foreign security restrictions, the Sudanese divestiture law from 2006, and restrictions on fixed income investments to primarily US Treasury Bonds and Agency Bonds, limit the overall rate of return the assets can generate. Limited investment returns require higher pension fund contributions from taxpayers.(See Appendix D)

2. The Illinois General Assembly legislates increases in pension benefits, but does not provide funding to offset the cost of those benefit increases. The additional costs are borne by taxpayers in Evanston, and every other municipality in Illinois that has a fire and police force.

3. The Fire and Police pension plans are Defined Benefit Plans. For over a decade, corporations have been changing their pension programs from Defined Benefit Plans towards Defined Contribution Plans. According to the Employee Benefit Research Institute, only 13% of private workers will be covered by Defined Benefit Plans by 2016.

4. Firemen and policemen are currently not eligible to receive Social Security Benefits.

5. Some states and organizations have consolidated their pension plans to achieve lower costs of operation and higher rates of return on (consolidated or pooled) assets (See Appendix D).

Longer Term Issues - Internal Actions

Is Evanston presenting its budget options to elected representatives in a way that provides for a sound decision making process? The City of Evanston has finite resources and needs to allocate and consume these resources within the revenue and income constraints of its citizens. While everyone generally wants "more" resources and services, we have to decide how much of a specific service is enough. It is important in this analysis to understand the "full cost" of the services provided. In the context of fire and police services which have Defined Benefit Pension Plans, understanding the total cost of salaries including fully loaded benefits is imperative. Budget documents should provide comparisons for the costs of each municipal service, along with ongoing evaluations of program and service effectiveness.

Longer Term Issues - Monitoring pensions and "best practices"

A strong working relationship between the City and its consulting actuary should be encouraged. An independent assessment of the actuarial model should be undertaken at least every three years. An independent assessment would help evaluate whether actuarial models are appropriate or should be adjusted.

IV. Appendices

Appendix A. – Changes in Actuarial Assumptions

Actuarial Assumption/Category	Police Fund	Fire Fund	Total
Unfunded Liability under prior actuary @ 3/1/2007	$54,675,000	$44,471,000	**$99,146,000**
Ongoing Experience(gain) Loss	2,880,000	(252,000)	2,628,000
Change in Actuary	1,535,000	2,229,000	3,764,000
Interest (Rate of Return on assets) was 7.5% now 7.25 %	4,059,000	3,164,000	7,223,000
Mortality Tables (was UP 84, now GAM 83) (1)	6,154,000	4,768,000	10,922,000
Cost Method (was PUC, now EAN) (2)	4,557,000	2,188,000	6,745,000
Other Demographic Assumptions (3)	3,716,000	6,052,000	9,768,000
Unfunded Liability under current actuary @ 3/1/2007	$77,576,000	$62,620,000	**$140,196,000**
Net Change			$41,050,000

(1) Prior Mortality Table, UP 84, assumed average total life expectancy for people retiring at age 53 is 77 years. Current Table, GAM 83, assumes people retiring at age 53 have average total life expectancy of 80 years. At 3/1/08, 20 police retirees and 26 fire retirees were ages 75 and older.

(2) Cost Method: PUC is Projected Unit Credit and EAN is Entry Age Normal.

(3) Prior actuary assumed avg. retirement age of 56 years. GRS assumes avg. retirement age of 54 years. Actual experience in Evanston based on 3/1/07 data shows average retirement age of 53 years.

Source: GRS presentation "Valuation Results as of 3/1/2007, and Assumption Review" 2/23/2008, p 6.

Appendix B. – Summary of Actuarial Methodology & Assumptions

The role of the actuary is to analyze the pension plans to determine, each year, the appropriate Annual Required Contribution (ARC)to provide sufficient funds to cover the pension liabilities. The ARC has two components:

1. Normal Cost
2. Amortization of the Unfunded Liability

1. The "Normal Cost" accrues annually as a result of the services provided by the fire and police officers and reflects the portion of retirement benefits earned in that year. Fire and police officers contribute over 9% of their paycheck to their retirement funds, and the City contributes approximately another 10%. However, since the pensions are Defined Benefit Plans, funds set aside may not be sufficient to meet the required amounts. The actuary has to make a number of assumptions to ensure that funds set aside today, will provide for future pension payments.

2. The "Amortization of the Unfunded Liability" is the contribution required annually to amortize the unfunded liability. Our unfunded liability at March 1, 2008 is $145.8mm. Under current Illinois law, the fire and police pension funds must be fully funded by 2033. Therefore, the amortization period is currently about 24 years.

The actuarial assumptions that determine the Annual Required Contribution are critical for the long term results and financial position of the pension funds. Appropriate assumptions which provide for the most likely scenario should serve to benefit the long term interests of the plan. Assumptions that are too conservative will result in over funding the pension fund which would shift the cost of the pension fund to earlier and current residents. Assumptions that are too aggressive will result in underfunding a pension fund and shift the cost to future generations. From a public policy perspective, each generation should pay the "fair" cost of services consumed each year to prevent shifting the full cost of fire and police services. The role of the actuary is critical in this process. The actuary is required to forecast many different variables, some with certainty, and others with wide degrees of variation. In a small statistical sample (The Fire Pension plan covers 232 members and the Police Pension Plan covers 326) these challenges become more difficult. When the experience deviates from the actuarial assumptions, tax-payers could be confronted with a financial liability. This is the current situation in Evanston.

In order to provide for the "fairest" plan, appropriate actuarial assumptions should be used. "Appropriate" is defined as the most probable outcome.

The following variables are most critical for the actuary to assess:

1. Rate of Return earned on pension assets.
2. Pay increases for employees.
3. Mortality rates of employees, retirees and beneficiaries.
4. Disability rates among employees.
5. Age of retirement patterns.
6. Employee departure rates prior to retirement period.

While cyclical deviations will naturally occur, causing a difference between estimated and actual annual results, these differences should even out over time. The BRC recommends that an independent auditor/actuary review the city's actuary every three years to assess the procedures and processes being utilized. Future deterioration in the unfunded liability resulting from aggressive assumptions can hopefully be prevented in the future. However, we would note the small sizes of both the Fire and Police Pension Plans present inherent challenges to the actuarial process. Modest deviations in actual experience from to the assumptions can significantly impact the results.

Appendix C. – Analysis of Pension Obligation Bonds

The Committee was provided materials presented by the City's financial consultant about proposed pension obligation bonds (POBs). Our subsequent discussion addressed the application of POBs and some of the perceptions surrounding this tool. The Committee considered examples of then-current yields for bond issues of similar credit, duration and tax status, in conjunction with investment assumptions/required performance.

Potential benefits of POBs include:

1. Maximizing the amount of time that dollars are invested, thus increasing investment proceeds.

2. Potential to lock-in the annual payment for a specific amount of unfunded liability for the term of the bonds.

3. The potential arbitrage presented by investment returns in excess of the interest rate being paid on the bonds.

At the time of our discussion, the spread between the expected total return on investments and the cost of funds did not justify issuing POBs. Several other factors also led the Committee to not recommend POBs:

1. Recent results for the pension fund investments had remained below both the actuarially assumed rate of return as well as the estimated interest rate on the bonds.

2. Illinois legislation restricts Fire and Police Pension Fund investment opportunities, which limits potential risk and reward on invested assets.

3. POBs would not insulate the Pension Funds from potential future increases in liabilities due to benefit changes, investment or other results, inconsistent with the actuarial assumptions. As a result, the City could find itself in a position in which the citizens were paying both debt service on the bonds, and paying down a newly emerged UAAL.

4. The possibility of over-funding the pensions.

As a result, the Committee agreed to recommend against POBs in the current interest rate and return environment, but to recommend that the City, the Pension Funds, and their teams of consultants continue to monitor the investment environment for a potential future opportunity.

Appendix D. - Analysis of Investment Performance

Investment Returns, 1998 - 2007

Year	Evanston Fire (1)		Evanston Police (2)		Illinois Municipal Retirement Fund		Median Public Defined Benefit Plan (Wilshire)		Pennsylvania School Employees' (3) Retirement System		Northwestern University (4)	
1998	NA	%	12.08	%	12.63	%	18.40	%	16.00	%	0.90	%
1999	NA		6.34		20.93		11.90		12.40		23.90	
2000	NA		4.71		1.87		5.80		12.20		31.40	
2001	1.89		2.46		-6.08		-2.20		-7.20		-10.40	
2002	0.72		0.56		-8.70		-5.90		-5.25		-8.70	
2003	9.69		10.85		22.60		3.84		2.74		8.10	
2004	5.90		6.50		12.40		16.34		19.67		15.10	
2005	5.03		4.90		8.70		9.72		12.87		19.08	
2006	7.35		9.02		13.90		10.66		15.26		14.39	
2007	7.22		6.98		8.50		17.46		22.93		21.14	
Approx Assets	$ 47 mm		$ 64 mm		$ 24 B				$ 68.5 B		$ 6.4 B	
$ 100 invested 10 years ago	$179.85	(5)	$185.72		$220.24		$208.62		$252.92		$275.90	
10 yr annual ret.	6.04%		6.38%		8.22%		7.63%		9.72%		10.68%	

(1) - Figures presented are from Mary Tomanek from Smith Barney. Not all fees are subtracted from reported results.
(2) - Figures presented are from David Wall from Wall & Associates. Not all fees are subtracted from reported results.
(3) - Figures presented are for fiscal year end June 30th of the stated year, data from website -

http://www.psers.state.pa.us/Publications/cafr/index.htm.
(4) - Figures presented are for fiscal year end August 31st of the stated year, data from Response to US Senate Committee, 2/25/08.
(5) - Returns assumed for 1998, 1999 & 2000 are from the Evanston Police actual results in order to create comparable 10 year numbers.

Appendix E. – Pension Related Contacts in Evanston and Springfield

Evanston Fire Pension Fund Board of Trustees – President - Patrick Dillon

Evanston Police Pension Fund Board of Trustees – President – Timothy Schoolmaster

State of Illinois General Assembly

House:

- Evanston Representatives –
  Elizabeth Coulson – District 17
  Julie Hamos – District 18
- Democratic Pension Staffer in House – Steve Zahn : szahn@hds.ilga.gov ;(217) 782-4497
- Republican Pension Staffer in House – Matt Paprocki: paprockim@housegopmail.state.il.us (217) 782-5219

Senate:

- Evanston State Senator – Jeff Schoenberg
-
- Appropriations & Legislative Analyst for Pensions and Investments Committee
- – Democrats - Sarah Mysiewicz : smysiewicz@senatedem.ilga.gov ; (217) 782-5242
- - Republicans – Eric Dillman : edillman@senategop.state.il.us ; (217) 558-1492
    - - Kim Fowler : kfowler@senategop.state.il.us ; (217) 782-0065

Illinois Department of Insurance (oversight for state pension funds per Illinois Legislation)

Illinois Municipal League-IML-(organization representing municipalities in Illinois)

Illinois Public Pension Fund Association-IPPFA-(organization comprised of Police and Fire Pension Funds)

V. Bibliography

1. Brainard, Keith, *Public Fund Survey: Summary of Findings for FY 2006*, National Association of State Retirement Administrators, October, 2007. (www.publicfundsurvey.org)
   Membership surveys include 85 percent of all state and local govt community in U.S. Funded ratios have declined from 101.3% in FY 2001 to 85.8% in FY 2006 across the U.S. This reflects a slowing of return on assets and not any acceleration in benefit enhancements on average. In response, employers have tended to slow the pace at which they enhance benefits and/or grant discretionary inflation adjustments as the decade advances (and financial pressures grow).
   Asset allocations: Averaged 59.5% in equities for Fiscal Year 2006.

2. Byrnes, Nanette, and Palmeri, Christopher, Business Special Report on Public Pensions, Sinkhole! How public pension promises are draining state and city budgets, June 13, 2005.

3. City of Evanston, February 28, 2007 Comprehensive Annual Financial Report, pages 86, 87.

4. City of Evanston, December 31, 2007, Proposed Budget for FY 2008-09, submitted by City Manager, Julia A. Carroll.

5. D'Arcy, Stephen, Optimal Funding of State Employee Pension Systems, The Journal of Risk and Insurance, 1999, Vol. 66, No.3, 355-380.

6. D'Arcy, Stephen, The Need for Guidance on Public Pension Funding, 2006 Advanced Actuarial Conference of ASPPA, Boston, MA. (Stephen D'Arcy is a Professor of Finance at University of Illinois).

7. Ford, William, *2002 Comparative Study of Major Public Employee Retirement Systems, Wisconsin Legislative Council*, December, 2003.
   This is a review/survey of all features of major individual state-local plans in the U.S.

8. Illinois Business Roundtable, Pension Funding, *The Consequence of Funding Deferred*, Illinois State Budget Series, December, 2005.
   The report lays out how deferred funding of mandated benefits in state employee funds has painted the Illinois State Legislature into a corner. An increasing share of natural revenue growth must now and will be allocated to funding pensions, with little left over for education, health care, and human services.

9. Illinois Compiled Statutes, Chapter 40, Act 5, Articles 3 and 4

10. Illinois Constitution, Article XIII, Section 5

11. Illinois Municipal League, *Fiscal Analysis of the Downstate Police, Fire, and IMRF Pensions Systems*, Springfield, February, 2007. Downstate police system pensions are generally in crisis.
From 1987 – 2004, the average funded ratio has fallen from 72.7% to 62.40%. Unfunded liability has grown from $400 million to $2.3 billion over the same period. Most of that erosion has taken place over this decade. Over the period, fixed income investments averaged 7.4%, equities 12.9%; blended 7.9% Two laws providing benefit increases for police plans (PA 91-0466 and PA 91-0939) carried combined average estimated cost of 2.22% of payroll, of which the employer funded an estimated 1.31%.

12. Pew Center on the States, "Promises with a Price-Public Sector Retirement Benefits", Susan Urahn, Managing Director.

13. Walsh, Mary Williams, "Major Changes Raise Concerns on Pension Bill," New York Times article, March 19, 2006.

14. Walsh, Mary Williams, "Once Safe, Public Pensions are Now Facing Cuts," New York Times article, November 6, 2006.

15. Roughly similar experiences on funding for fire systems took place over the period. Benefit enhancements in PA 91-0466 (Effective 2000) and PA 93-0689 (effective 2005) carried a combined est'd cost of 7.145 % of payroll, of which 5.94% funded by employer. A general conclusion of this and a companion report (9/19/07) is that benefit enhancements have pressured local pension systems; State government in Illinois has mandated additional benefits but not provided the necessary funds. In fact, at the same time, property tax limits—tax caps—have limited revenues for non home rule govts to pay for pension obligations. Constraints on investing fund portfolios in equities have also contributed to poor returns on investment.

16. Pam, Robert, Government Finance Officers Association, *A Guide for Selecting Pension Actuarial Consultants*, Chicago, Illinois, 1998.
The guide includes sample forms on diskettes (now online) and examples of RFPs from governments around the U.S.

17. Civic Federation of Chicago, *Pension Fund Actuarially Required Contributions (ARC)*, February 14, 2007 The brief describes the 6 permitted cost methods permitted to calculate ARC for normal cost under GASB 25 & 27. Requirements for ARC by all Illinois Pension systems are described. 18. Fowler, Mark, *Preserving the Long-Term Solvency of Public Safety Pension Funds,* Northwest Municipal Conference, presentation made at Mount Prospect Village Hall, March 31, 2008.
"Forty-three NWMC member municipalities are carrying a combined $1.047 billion

in unfunded police and firefighter pension liabilities" according to ILL Department of Financial and Professional Regulation.

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The report cites agreement that each generation of taxpayers should pay the full cost of the public services it receives. In the case of defined benefit pension plans, this means the cost of benefit should be paid for in the year in which it was earned.

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The GFOA Board has agreed on recommended practices, many of which have already been adopted and/or codified by Illinois governing statutes or the Government Accounting Standards Board.

Websites :

i. Illinois Municipal Retirement Fund (IMRF) - http://www.imrf.org/

ii. Illinois Public Pension Fund Association (IPPFA) - http://www.ippfa.org/

iii. Illinois Municipal League (IML) - http://www.iml.org/