MOODY'S
INVESTORS SERVICE

ISSUER COMMENT

Illinois Pension Reform Legislation Is Credit Positive

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Illinois Governor Pat Quinn yesterday signed a bill (Senate Bill 1) that, according to legislative documents, reduces the state's unfunded pension liability by about 20%, a credit positive for Illinois (A3, negative), the lowest-rated US state. The reforms face a legal challenge from organized labor but, if implemented, we believe they will substantially ease the pension funding pressure that has helped trigger five Illinois downgrades since early 2009. Illinois' unfunded pension liabilities – which totaled $100 billion in June 2013 on an as-reported basis, or $173 billion according to Moody's adjusted net pension liability calculation – are the largest of any US state. The state General Assembly's passing of SB 1 on December 3 ended a multi-year impasse over how to reverse severe deterioration in the state's pension funds.

Formal actuarial data on reforms' effects still to be evaluated

We have yet to receive formal actuarial data detailing SB 1's effects on accrued pension liabilities and future state contribution requirements, but we will evaluate them, when available. The preliminary estimates disclosed by the state legislature say the reforms will lower contributions during the next 30 years by $160 billion in nominal terms, to $214 billion, while putting the state pensions on a path to full funding over a closed, 30-year period. The state expects to reduce its contribution in the first year after implementation by $1.2 billion, or 20%, according to the legislative figures. The savings come from reforms affecting current members of the State Employees' Retirement System (SERS), the State Teachers' Retirement System (STRS), the State Universities Retirement System (SURS) and the General Assembly Retirement System (GARS), which account for the bulk of the state's unfunded pension liability. SB 1's reforms do not apply to the fifth statewide plan, for judges.

Supplemental contributions may help state reach full funding faster

Including the impact of supplemental funds provided for in the law, the legislature expects the public pensions to reach fully-funded status in about 25 years. Prior governing statute, by contrast, required annual state contributions based on a goal of achieving an actuarial assets-to-liability ("funded") ratio of 90% over 50 years. Supplemental contributions would be derived from two sources: 10% of savings from cost of living adjustment (COLA) and other pension plan changes and the revenue currently being used to provide debt service on two pension funding bonds issued in 2010 and 2011. The last of those bonds mature during fiscal 2019, when debt service requirements total $900 million. These supplemental funds, which will total more than $1 billion annually starting in fiscal 2020, would be deposited into the Pension Stabilization Fund in the state treasury and transferred monthly to the systems. These supplemental payments will not be used to reduce the state's base contributions, which under SB 1 must be enough to achieve full amortization of unfunded liabilities over a 30-year period.

Savings derived from changes in COLA policy and other reforms

The state expects to be able to both reduce its annual funding burden and its pension accrued liabilities because of changes to existing policies. Reduced cost-of-living adjustments for Tier I workers (those hired before 2011) account for most of SB 1's expected savings. Prior COLA policy provided these workers with a 3%, compounded benefit boost each year. SB 1 provides for a mix of staggered COLA suspensions (see Exhibit 1), limits on COLA-eligible benefits, and removal of COLA compounding for many workers. The youngest workers (those 43 and under) will face five COLA suspensions. Through age brackets rising to age 50, the law assigns progressively fewer COLA suspensions; 50-year-olds are given only one. Total benefits on which employees receive COLAs are further capped at the lesser of 3% times the total annuity payable at the time of the COLA or 3% times $1,000 (or $800 for those employees coordinated with Social Security), multiplied by years of service. The dollar multipliers will be adjusted by inflation, but COLAs for many employees no longer will be compounded, except for those receiving annuities below the threshold years-of-service times $1,000 (or $800 if under Social Security). In addition, the reforms impose increased minimum retirement ages, on a sliding scale up to 60 months based on age, for workers who are younger than 46 as of the effective date. In exchange for these reforms, the law cuts employee contribution requirements 1 percentage point, among other benefits.

EXHIBIT 1

COLA Suspension Under SB-1

Age Group	Years of COLA Suspension
50 and over	Year 2
47-49	Years 2, 4, and 6
44-46	Years 2, 4, 6, and 8
43 and under	Years 2, 4, 6, 8, and 10

Source: Illinois General Assembly

Many states have enacted reforms affecting COLA policy

Many states that have enacted pension reforms in recent years have relied on changes to COLA policy (see Exhibit 2). Illinois' reforms may be the largest reform package implemented by any US state.

EXHIBIT 2

Overview of Legislation Reducing State Pensions' Accrued Liabilities

State	Rating/ Outlook	Elements of Legislative Pension Reform(s)	Liability Reduction (000s)
Colorado	Aa1/Stable	COLA caps, increase age/service requirements; contribution rate changes	$8,800,000
Florida	Aa1/Stable	Prospective COLA elimination, employee contribution increase	$1,100,584
Illinois	A3/Negative	COLA policy modifications, increased retirement age, salary cap	$21,000,000
Montana	Aa1/Stable	COLA reductions, increases to both employee and employer contributions	$982,441
New Jersey	Aa3/Stable	COLA elimination, increased retirement age for new employees	$18,484,030
Oklahoma	Aa2/Stable	COLA elimination	$5,632,000

Liability reduction figures are derived from state and pension-plan sources and represented expected unfunded accrued liability reduction at time reforms were enacted.

Litigation from employee unions is expected to delay implementation

Whether the reforms withstand expected litigation remains to be seen. Employee unions assert that the law runs afoul of the state constitution's ban on reduction of public pension benefits. The state Supreme Court likely will decide which side is correct, and the legal process will take time. The state legislature has estimated that implementation may be delayed until January 1, 2015. Key legal arguments probably will center on issues such as whether employees were given fair compensation and whether COLAs are themselves part of the constitutionally shielded benefits. Judges in some states have held that COLAs differ from the benefits on which they are paid, but others have seen COLAs as protected by contractual provisions or case law. Such rulings from other states are unlikely to determine the outcome in Illinois courts. An Illinois Supreme Court ruling allowing SB 1 to be implemented would allow us to fully factor the reforms into our rating.

For more information on Moody's insights on employee pensions and the related credit impact on companies, governments, and other entities across the globe please visit Moody's on Pensions at www.moodys.com/pensions

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