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Second tier pension benefits created for firefighters and police officers in Illinois under new law

by Carolyn Welch Clifford

Amidst a flurry of controversy, Governor Quinn signed S.B. 3538 into law on December 30, 2010, creating significant changes to pension benefits for new full-time firefighters and police officers hired on or after January 1, 2011. The new law does not affect the pension benefits of active or retired firefighters or police officers who are currently members of a pension fund. New P.A. 96-1495 was effective January 1, 2011.

What is the new expanded investment authority for Article 3 and 4 Funds? -- P.A. 96-1495 adds "Illinois Metropolitan Investment Funds, and interest bearing funds or pooled accounts," and "corporate bonds managed through an investment advisor" as new fixed income investment options for all Article 3 and 4 pension funds, regardless of the size of the fund's assets. (40 ILCS 5/1-113.2(8) and (14)) The new law includes two restrictions regarding corporate bond investments: (1) The bonds must be rated as investment grade by one of the two largest rating services at the time of purchase; and (2) If subsequently downgraded below investment grade, the bonds must be liquidated from the portfolio within 90 days after being downgraded by the manager. (40 ILCS 5/1-113.2(14)(1 and 2)) For those fire and police pension funds with net assets of $10,000,000 or more and which have also appointed an investment advisor, P.A. 96-1495 allows additional investment in equities of up to 50% of the fund's total assets beginning July 1, 2011, and up to 55% of the fund's total assets beginning July 1, 2012. (40 ILCS 5/1-113.4a (new))

What are the new Tier Two benefits for new firefighters and police officers? -- Similar to changes to various statewide pension systems approved last spring, full-time firefighters and police officers hired by an Illinois fire protection district or municipality beginning January 1, 2011, will receive more modest pension benefits than current members of Article 3, 4, 5, 6 and 7 funds.

***Change in retirement vesting* --** P.A. 96-1495 provides that firefighters and police officers at age 55 with 10 or more years of creditable service will be entitled to a retirement pension at 2.5% of his or her "final average salary" for each year of service. At age 50, firefighters and police officers under Tier Two may retire if they have 10 or more years of creditable service, but their retirement benefit will be reduced by 0.5% for each month that the firefighter or police officer is under age 55. The maximum retirement pension for Tier Two firefighters and police officers is 75% of "final average salary." (40 ILCS 5/4-109(c); 40 ILCS 5/3-111(d))

***"Final average salary"* --** The new law specifically changes the current method of determining final salary for retirement pension purposes. For Tier Two firefighters and police officers, the new law provides that "final average salary" for purposes of calculating retirement benefits is, "[T]he average monthly salary obtained by dividing the total salary . . . during the 96 consecutive months of service within the last 120 months of service in which the total salary was the highest by the number of months of service in that period. (40 ILCS 5/4-109(c); 40 ILCS 5/3-111(d))

***Salary cap on pension benefits* --** For Tier Two firefighters and police officers, a salary cap for pension benefit purposes has been established. Under P.A. 96-1495, the "applicable annual salary" for all purposes under the Illinois Pension Code (including without limitation the calculation of benefits and employee contributions) shall not exceed $106,800. The cap shall be increased annually by the lesser of 3% or one-half the consumer price index-urban (CPI-U). Pension contributions would be calculated and capped on the first $106,800 of pensionable salary (as annually increased by the new statute) for Tier Two firefighters and police officers, if their pensionable salary exceeds $106,800. (40 ILCS 5/4-109(c); 40 ILCS 5/3-111(d))

Have disability benefits for Tier Two members changed? -- For disability pension purposes, Tier Two firefighters and police officers (like Tier One firefighters and police officers) will receive benefits based upon the final monthly salary attached to their rank. (40 ILCS 5/4-110, 4-110.1 and 4-111; 40 ILCS 5/3-114.1, 3-114.2 and 3-114.3) The new law does not amend the disability statutory provisions for Tier Two firefighters and police officers in any respect.

What was the effect on annual cost of living increases? -- The new law reduces the annual cost of living increases for Tier Two firefighters and police officers receiving pension benefits to track the consumer price index–urban (CPI-U). Upon the attainment of age 60 or the first anniversary of the pension start date (whichever is later), P.A. 96-1495 provides the annual increase shall be calculated at 3% or one-half the unadjusted percentage increase (but not less than zero) in the CPI-U, whichever is less, of the originally granted pension. If the annual unadjusted percentage change in the CPI-U is zero – or reflects a decrease over the preceding period – then the pension shall not be increased. (40 ILCS 5/4-109.1(g) and 3-111.1(g))

Have survivor benefits for Tier Two members changed? -- Survivors of Tier Two firefighters and police officers will receive reduced initial benefits, but will receive annual increases, unlike their Tier One surviving spouse peers. The new law provides that "survivors" of Tier Two firefighters and police officers shall receive survivor benefits in the amount of 66 2/3% of the firefighter's or police officer's "earned pension" at the date of death. The new law specifically provides that this does not diminish the survivor benefits currently provided for a surviving spouse of a firefighter who dies of a duty-related sickness, accident or injury under Section 4-114(j). All surviving spouses who qualify under Section 4-114(j) for enhanced surviving spouse benefits shall be entitled to 100% of the salary attached to the rank held by the deceased firefighter on the last day of service. (40 ILCS 5/4-114(j)) New for Tier Two survivors are annual cost of living increases. Currently, only surviving minor children of Tier One firefighters receive annual increases on their benefits. Upon the attainment of age 60, the new law provides that survivors of Tier Two firefighters and police officers shall receive annual increases on their benefits of 3% or one-half the annual unadjusted percentage increase in the CPI-U, of the originally granted survivor's pension. (40 ILCS 5/4-114; 40 ILCS 4/3-112))

How will employer contributions be determined under the new law? -- Amendments to Section 4-118 and Section 3-125 now provide for several significant changes to how the municipality's contribution to the fire or police pension fund is calculated. In the short term, these changes not only will reduce the required employer contribution, but also will likely create cash flow problems for many fire and police pension funds.

- The annual actuarially-determined employer contribution shall now be calculated to determine an amount sufficient to bring the total fund's assets up to 90% (currently, 100%) of the total actuarial liability of the fund by the end of the municipal fiscal year 2040 (currently, calendar year 2033), as determined by the DOI or an enrolled actuary retained by the fund or the municipality.

- New subsection (a-5) of Section 4-118 and new subsection (b) of Section 3-125 provide for a five-year "smoothing" technique.

- The new mandatory method for calculating the required employer contribution will now be the "projected unit credit actuarial cost method." "Entry-age normal cost method" was previously used by the DOI and most actuaries to calculate the employer's contribution. Because this method was first introduced in the eleventh-hour in the final version of the pension reform bill and has drawn harsh criticism, some believe it may be subject to further review and legislative action in a trailer bill. (40 ILCS 5/4-118(a); 40 ILCS 5/3-125(a))

Is there an enforcement mechanism to insure employer contributions? -- New subsection (b-5) of Section 4-118 and new subsection (c) of Section 3-125 outline the controversial funding enforcement mechanism which is to be phased in beginning in fiscal year 2016. They mirror a similar process under Section 7-172.1(a) of the Illinois Pension Code, which is the funding enforcement mechanism for IMRF. (40 ILCS 5/7-172.1(a)) If a municipality fails to transmit the pension fund contributions required of it for more than 90 days after the payment is due, the fund may certify to the State Comptroller the amounts of the delinquent payments, after giving notice to the municipality. The State Comptroller must deduct and deposit into the pension fund the certified amounts or a portion of those amounts from the "grants" of State funds to the municipality. (40 ILCS 5/4-118(b-5) and 3-125(c)) Note that the phased-in enforcement mechanism does contemplate that municipalities are excused from proper funding until 2016.

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