STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

2014 ANNUAL REVIEW

INFORMATION SUBMITTED BY THE RETIREMENT PLAN FOR CTA EMPLOYEES

NOVEMBER 2014

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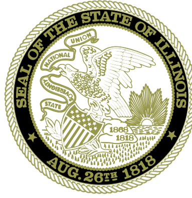

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OFFICE OF THE AUDITOR GENERAL
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To the Legislative Audit Commission, the Speaker and Minority Leader of the House of Representatives, the President and Minority Leader of the Senate, the members of the General Assembly, and the Governor:

This is our 2014 Annual Review of Information Submitted by the Retirement Plan for Chicago Transit Authority Employees.

The review was conducted pursuant to Public Act 95-708 which amended the Illinois State Auditing Act by adding a requirement for the Auditor General to annually review and report on information submitted by the Board of Trustees of the Retirement Plan for Chicago Transit Authority Employees.

The report for this review is transmitted in conformance with Section 5/3-2.3(e) of the Illinois State Auditing Act.

WILLIAM G. HOLLAND
Auditor General

Springfield, Illinois
November 2014

STATE OF ILLINOIS
OFFICE OF THE
AUDITOR GENERAL
William G. Holland, Auditor General

SUMMARY REPORT DIGEST

REVIEW OF INFORMATION SUBMITTED BY THE RETIREMENT PLAN FOR CHICAGO TRANSIT AUTHORITY EMPLOYEES

2014 ANNUAL REVIEW
Release Date: November 2014

SYNOPSIS

The Illinois State Auditing Act requires the Retirement Plan for Chicago Transit Authority Employees (Retirement Plan) to submit to the Office of the Auditor General (OAG) an audit, an annual statement, and an actuarial statement by September 30 of each year. On September 30, 2014, the OAG received these documents from the Retirement Plan. The OAG reviewed these documents and concluded that the Retirement Plan had complied with the requirements established in the Auditing Act.

The Illinois Pension Code (40 ILCS 5/22-101(e)(3)) requires the Retirement Plan to determine, based on a report prepared by an enrolled actuary, the estimated funded ratio of the Retirement Plan's total assets to its total actuarially determined liabilities. The Plan is also required to determine the employee and employer contribution rates needed to meet funding requirements established by the Pension Code. The Auditor General is required to review the determination and the assumptions on which it is based and determine whether they are *"unreasonable in the aggregate"*. This report does not constitute an audit as that term is defined in generally accepted government auditing standards.

The OAG and our consultants, Aon Hewitt, reviewed the Retirement Plan's assumptions contained in the January 1, 2014 Actuarial Valuation and concluded that they were not unreasonable in the aggregate. However, the Plan should conduct reviews of the following three assumptions prior to next year's valuation:

- Investment return assumption: While the January 1, 2014 Valuation lowered the investment return assumption from 8.50 percent to 8.25 percent, it remains at the upper end of investment return assumptions used by other plans. We recommend that the Plan annually review the reasonableness of its investment return assumption, rather than wait for the next experience study.
- Mortality assumption: The mortality assumptions used by the Plan were changed in the January 1, 2014 Valuation to account for future mortality improvements. However, the assumptions were chosen before final 2014 mortality tables were issued by the Society of Actuaries. We recommend that the Plan's mortality experience be reviewed next year based on the new tables.
- Active participant assumption: Over the past five years, the headcount of active plan members (i.e., employees) has been declining. Given the impact such a decline can have on future contribution levels, we recommend that the Plan review the use of a constant headcount.

The contribution rates adopted by the Retirement Plan Board for 2015 remained unchanged from the 2014 contribution rates: 14.250 percent of pay for the employer rate (which is net of the employer debt service credit of 6% of pay) and 10.125 percent of pay for employees.

The funded ratio of the Retirement Plan increased slightly from 59.4 percent as of January 1, 2013, to 60.9 percent as of January 1, 2014. At January 1, 2014, the Plan's assets totaled $1.893 billion and the actuarial accrued liability was $3.106 billion, according to the Plan's January 1, 2014 Actuarial Valuation.

ANNUAL REVIEW RESULTS AND CONCLUSIONS

STATUTORY REQUIREMENTS

The OAG reviewed the documents submitted by the Retirement Plan and concluded the Retirement Plan had complied with the Auditing Act.

The Illinois State Auditing Act (30 ILCS 5/3-2.3(e)) requires the Retirement Plan for Chicago Transit Authority Employees (Retirement Plan) to submit to the Office of the Auditor General (OAG) an audit, an annual statement, and an actuarial statement by September 30 of each year.

- On September 30, 2014, the OAG received these documents from the Retirement Plan.
- The OAG reviewed these documents and concluded that the Retirement Plan had complied with the requirements established in the Auditing Act.

In addition, the Illinois Pension Code (40 ILCS 5/22-101(e)(3)) requires the Retirement Plan to determine, based on a report prepared by an enrolled actuary, the estimated funded ratio of the Retirement Plan's total assets to its total actuarially determined liabilities.

- The Plan is also required to determine the employee and employer contribution rates needed to meet funding requirements established by the Pension Code.
- The Auditor General is required to review the determination and the assumptions on which it is based and determine whether they are *"unreasonable in the aggregate"*. (pages 3-4)

REVIEW OF ACTUARIAL VALUATION

The Retirement Plan submitted the Actuarial Valuation as of January 1, 2014, to the OAG on September 30, 2014. This Actuarial Valuation was presented to the Retirement Plan Board at its September 25, 2014 meeting. At that meeting, the Board of Trustees accepted the January 1, 2014 Actuarial Valuation and certified the employer and employee contribution rates for 2015.

The Retirement Plan's assumptions were not unreasonable in the aggregate.

The OAG and our consultants, Aon Hewitt, reviewed the Retirement Plan's assumptions contained in the January 1, 2014 Actuarial Valuation and concluded that they were not unreasonable in the aggregate. However, the Plan should conduct additional reviews of three of the assumptions prior to next year's valuation. The three assumptions are investment

return, mortality, and the number of active participants in future years.

The Plan's actuary completed an experience study for the five year period ending December 31, 2012. An experience study assesses how well assumptions used by the Plan align with the actual experience of the Plan. If past experience differs from the assumptions used, then the actuary may recommend revisions to the assumptions used in future valuations.

As a result of the experience study, the actuary recommended lowering the investment return assumption from 8.50 percent to 8.25 percent. This recommended change was incorporated into the January 1, 2014 Actuarial Valuation. Our prior reviews have concluded that the investment return assumptions previously used by the Plan were at the upper range of investment return assumptions for comparable plans. While the investment return assumption was lowered to 8.25 percent, it remains at the upper end of investment return assumptions used by other plans. We recommend that the Plan annually review the reasonableness of its investment return assumption, rather than wait for the next experience study.

The Plan's actuary also recommended certain demographic assumptions be revised as a result of the experience study, including rates of retirement, mortality, disability, and salary increases. The mortality assumptions used by the Plan were changed in the January 1, 2014 Valuation to account for future mortality improvements. However, the assumptions were chosen before final 2014 mortality tables were issued by the Society of Actuaries. We recommend that the Plan's mortality experience be reviewed next year, on a benefits weighted basis, based on the new tables.

One assumption that was unchanged was the use of a constant headcount assumption. Over the past five years, the headcount of active plan members (i.e., employees) has been declining every year. Given the continued decline in active members, and the impact such a decline can have on future contribution levels, we recommend that the Plan review this assumption.

January 1, 2014:
- **Assets . . . . $1.893 billion**
- **Liabilities . . . . .$3.106 billion**
- **Funded Ratio 60.9%**

The funded ratio of the Retirement Plan increased slightly from 59.4 percent as of January 1, 2013, to 60.9 percent as of January 1, 2014. At January 1, 2014, the Plan's assets totaled $1.893 billion and the actuarial accrued liability was $3.106 billion, according to the Plan's January 1, 2014 Actuarial Valuation. (pages 4-12)

CONTRIBUTION RATES

The Pension Code requires the CTA to contribute 12 percent of pay, less up to a 6 percent credit for debt service paid on the

bonds issued for contribution to the Retirement Plan; employees are required to pay 6 percent of pay. The Pension Code further requires that contribution rates be increased if the funded ratio is projected to decline below 60 percent prior to 2040, with the CTA paying two-thirds and employees one-third of the required contribution.

The employee and employer contribution rates remained unchanged for 2015: the employee contribution rate was 10.125% of pay and the employer contribution rate was 14.250% of pay (the employer contribution rate is net of the debt service credit of 6% of pay).

The contribution rates adopted by the Retirement Plan Board for 2015 remained unchanged from the 2014 contribution rates which were 14.250 percent for the employer (which is net of the employer debt service credit of 6% of pay) and 10.125 percent for employees. (pages 11, 12)

A draft of this Review was provided to the Retirement Plan for their review. This report does not constitute an audit as that term is defined in generally accepted government auditing standards.

WILLIAM G. HOLLAND
Auditor General

WGH:JS

This Annual Review was conducted by OAG staff with the assistance of our consultants, Aon Hewitt.

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2014 Annual Review

Information Submitted by the Retirement Plan for CTA Employees

The Illinois State Auditing Act (30 ILCS 5/3-2.3(e)), as amended by Public Act 95-708, requires the Auditor General to review certain documents submitted by the Board of Trustees of the Retirement Plan for Chicago Transit Authority Employees (Retirement Plan). In addition, the Illinois Pension Code (40 ILCS 5/22-101(e)(3)) requires the Retirement Plan to determine, based on a report prepared by an enrolled actuary, the estimated funded ratio of the Retirement Plan's total assets to its total actuarially determined liabilities. The Plan is also required to determine the employee and employer contribution rates needed to meet funding requirements established by the Pension Code. The Auditor General is then required to review the determination and the assumptions on which it is based and determine whether they are "unreasonable in the aggregate".

REPORT CONCLUSIONS

The Auditing Act (30 ILCS 5/3-2.3(e)) requires the Retirement Plan to submit to the Office of the Auditor General (OAG) an audit, an annual statement, and an actuarial statement by September 30 of each year. On September 30, 2014, the OAG received these documents from the Retirement Plan. The OAG reviewed these documents and concluded that the Retirement Plan had complied with the requirements established in the Auditing Act.

In addition, the Illinois Pension Code (40 ILCS 5/22-101(e)(3)) requires the Retirement Plan to determine, based on a report prepared by an enrolled actuary, the estimated funded ratio of the Retirement Plan's total assets to its total actuarially determined liabilities. The Plan is then required to determine the employee and employer contribution rates needed to meet funding requirements established by the Pension Code. The Auditor General is required to review the determination and the assumptions on which it is based and determine whether they are "unreasonable in the aggregate".

The Retirement Plan submitted the Actuarial Valuation as of January 1, 2014, to the OAG on September 30, 2014. This Actuarial Valuation was presented to the Retirement Plan Board at its September 25, 2014 meeting. At that meeting, the Board of Trustees accepted the January 1, 2014 Actuarial Valuation and certified the employer and employee contribution rates for 2015.

The OAG and our consultants, Aon Hewitt, reviewed the Retirement Plan's assumptions contained in the January 1, 2014 Actuarial Valuation and concluded that they were not unreasonable in the aggregate. However, the Plan should conduct

additional review of three of the assumptions prior to next year's valuation. The three assumptions are investment return, mortality, and the number of active participants in future years.

The Plan's actuary completed an experience study for the five year period ending December 31, 2012. An experience study assesses how well assumptions used by the Plan align with the actual experience of the Plan. If past experience differs from the assumptions used, then the actuary may recommend revisions to the assumptions used in future valuations.

As a result of the experience study, the actuary recommended lowering the investment return assumption from 8.50 percent to 8.25 percent. This recommended change was incorporated into the January 1, 2014 Actuarial Valuation. Our prior reviews have concluded that the investment return assumptions previously used by the Plan were at the upper range of investment return assumptions for comparable plans. While the investment return assumption was lowered to 8.25 percent, it remains at the upper end of investment return assumptions used by other plans. We recommend that the Plan annually review the reasonableness of its investment return assumption, rather than wait for the next experience study.

The Plan's actuary also recommended certain demographic assumptions be revised as a result of the experience study, including rates of retirement, mortality, disability, and salary increases. The mortality assumptions used by the Plan were changed in the January 1, 2014 Valuation to account for future mortality improvements. However, the assumptions were chosen before final 2014 mortality tables were issued by the Society of Actuaries. We recommend that the Plan's mortality experience be reviewed next year, on a benefits weighted basis, based on the new tables.

One assumption that was unchanged was the use of a constant headcount assumption. Over the past five years, the headcount of active plan members (i.e., employees) has been declining every year. Given the continued decline in active members, and the impact such a decline can have on future contribution levels, we recommend that the Plan review this assumption.

The Pension Code requires the CTA to contribute 12 percent of pay, less up to a 6 percent credit for debt service paid on the bonds issued for contribution to the Retirement Plan; employees are required to pay 6 percent of pay. The Pension Code further requires that contribution rates be increased if the funded ratio is projected to decline below 60 percent prior to 2040, with the CTA paying two-thirds and employees one-third of the required contribution.

The contribution rates adopted by the Retirement Plan Board for 2015 remained unchanged from the 2014 contribution rates which were 14.250 percent for the employer (which is net of the employer debt service credit of 6% of pay) and 10.125 percent for employees. The January 1, 2014 Actuarial Valuation concluded that these contribution rates should allow the Plan to remain above the required 60 percent funding level and

result in the Plan being funded at 97.4 percent by 2039. However, the Plan's actuary noted that should market losses result in a decline in the Plan's assets, then increased employee and employer contributions would be required in future years.

The funded ratio of the Retirement Plan increased slightly from 59.4 percent as of January 1, 2013, to 60.9 percent as of January 1, 2014. At January 1, 2014, the Plan's assets totaled $1.893 billion and the actuarial accrued liability was $3.106 billion, according to the Plan's January 1, 2014 Actuarial Valuation.

BACKGROUND

The Retirement Plan for CTA Employees was significantly underfunded, with a funded ratio of 34 percent as of January 1, 2006. In addition, the Plan was responsible for administering both the retirement benefits and retiree health care benefits. Public Act 94-839 required the CTA to separate the funding for retiree health care benefits from the funding of the retirement system by January 1, 2009.

Public Act 95-708 made sweeping changes to the Retirement Plan for CTA Employees. Public Act 95-708 gave the CTA the authority to issue bonds to help fund both the retirement and retiree health care plans. Public Act 95-708 also established the Retiree Health Care Trust to handle the retiree health care benefits. The Retiree Health Care Trust was established in May 2008.

The legislation required that the contributions from the CTA and employees must be at a level so that the funded ratio of the Retirement Plan does not decline below 60 percent in any year before 2040, and achieve 90 percent funding by the end of 2059. If the Plan's funded ratio declines below 60 percent, the Pension Code requires the Board to "determine the increased contribution required each year as a level percentage of payroll during the years after the then current year . . . so the funded ratio is projected to reach at least 60% no later than 10 years after the then current year and include that determination in its report." It also stipulates that employees are required to pay one-third of the annual required contribution and the CTA is required to pay two-thirds of the required contribution. During the time period 2009 through 2040, the amount paid by the CTA with respect to debt service on bonds issued for contribution to the Retirement Plan shall be treated as a credit against the amount of required contribution, up to an amount not to exceed six percent of the compensation paid by the CTA in the following year.

REVIEW OF RETIREMENT PLAN SUBMISSIONS

The Illinois State Auditing Act (30 ILCS 5/3-2.3(e)) requires the Retirement Plan to submit certain specific documents to the Auditor General by September 30 of each year:

1. **Audit.** The most recent audit or examination of the Retirement Plan;

2. **Annual Statement.** An annual statement containing the information specified in Section 1A-109 of the Illinois Pension Code (see inset); and

3. **Actuarial Statement.** A complete actuarial statement applicable to the prior plan year, which may be the annual report of an enrolled actuary retained by the Retirement Plan specified in Section 22-101(e) of the Illinois Pension Code.

ILLINOIS PENSION CODE REQUIREMENTS
The Auditing Act requires the CTA Retirement Plan to annually file with the Auditor General the following information specified in Section 1A-109 of the Pension Code: (1) a financial balance sheet as of the close of the fiscal year; (2) a statement of income and expenditures; (3) an actuarial balance sheet; (4) statistical data reflecting age, service, and salary characteristics concerning all participants; (5) special facts concerning disability or other claims; (6) details on investment transactions that occurred during the fiscal year covered by the report; (7) details on administrative expenses; and (8) such other supporting data and schedules as in the judgement of the Division may be necessary for a proper appraisal of the financial condition of the pension fund and the results of its operations. The annual statement shall also specify the actuarial and interest tables used in the operation of the pension fund.
Source: Pension Code (40 ILCS 5/1A-109) and Auditing Act (30 ILCS 5/3-2.3(e))

On September 30, 2014, the OAG received the three documents listed below from the Retirement Plan. We reviewed the documents and concluded the information required by Section 5/3-2.3(e) of the Auditing Act was contained in these reports:

- Audited Financial Statements for the Retirement Plan for the year ended December 31, 2013;

- Section II of the Investment Performance Report for the period ended December 31, 2013; and

- January 1, 2014 Actuarial Valuation for the Retirement Plan.

Review of Actuarial Determination and Assumptions

The Illinois Pension Code (40 ILCS 5/22-101(e)(3)) places an additional reporting requirement on the Auditor General. The Code requires that the Retirement Plan, *"By September 15 of each year beginning in 2009 and ending on December 31, 2039, on the basis of a report prepared by an enrolled actuary retained by the Plan, the Board of Trustees of the Retirement Plan shall determine the estimated funded ratio of the total assets of the Retirement Plan to its total actuarially determined liabilities. A report containing that determination and the actuarial assumptions on which it is based shall be filed with the . . . Auditor General . . . ."* The Pension Code requires the Auditor General to review the determination and the assumptions on which it is based to determine whether they are unreasonable in the aggregate.

The January 1, 2014 Actuarial Valuation was presented to the Retirement Plan Board at its September 25, 2014, meeting. At that meeting, the Board of Trustees accepted the January 1, 2014 Actuarial Valuation and certified the employer and employee contribution rates for 2015. The 2015 rates adopted were unchanged from the 2014 contribution rates: the employer contribution rate was 14.25 percent (which is net of the employer debt service credit of 6% of pay) and the employee contribution rate was 10.125 percent.

Review of Actuarial Assumptions Used

In 2014, the Plan's actuary completed an experience study evaluating the key demographic and economic assumptions of the Plan. An experience study assesses how well assumptions used by the Plan align with the actual experience of the Plan. If past experience differs from the assumptions used, then the actuary may recommend revisions to the assumptions used in future valuations. The study examined five years of Plan history, from January 1, 2008 to December 31, 2012. Several of the assumptions used in the Plan's January 1, 2014 Actuarial Valuation were revised based on the results of the experience study.

On September 30, 2014, the Retirement Plan submitted to the Auditor General its Actuarial Valuation as of January 1, 2014, pursuant to 40 ILCS 5/22-101(e)(3). Our consultants, Aon Hewitt, reviewed the assumptions used in the Retirement Plan's Actuarial Valuation and found that the assumptions used were not unreasonable in the aggregate.

While the assumptions used in the January 1, 2014 Actuarial Valuation were not unreasonable in the aggregate, three assumptions, the investment return assumption, the mortality assumption, and the active participant assumption, warrant additional discussion.

Investment Return Assumption

Our prior reviews have concluded that the investment return assumptions previously used by the Plan were at the upper range of investment return assumptions for comparable plans. In our 2009 and 2010 Annual Reviews, we noted that the Retirement Plan's investment return assumption of 8.75 percent, while selected using established standards for pension plans, was an optimistic assumption. In the January 1, 2011 Actuarial Valuation, the Board's actuary recommended, and the Board approved, a reduction in the investment return assumption to 8.50 percent.

In the January 1, 2012 and January 1, 2013 Actuarial Valuations, the investment return assumption remained at 8.50 percent. Both Valuations contained no analysis justifying the reasonableness of the 8.50 percent rate of return or a presentation of

different rates of return and the impact they would have on the required contribution rates.

In the January 1, 2014 Valuation, the investment return assumption was reduced from 8.50 percent to 8.25 percent. As part of the experience study performed for the January 1, 2014 Valuation, the Plan's actuary examined the reasonableness of the 8.50 percent investment return assumption. In a presentation to the Retirement Board on March 14, 2014, the actuary calculated expected annualized compound returns over different periods. For the 50th percentile (i.e., there is a 50% chance of achieving the projected rate), the actuary estimated rates of return of 7.33 percent for a 10 year period, 8.42 percent for a 20 year period, and 8.76 percent for a 30 year period. The actuary noted that while maintaining the 8.50 percent investment return assumption is acceptable, a lower return should be considered. The actuary provided results if the rate was lowered to 8.00 percent and 7.50 percent. A reduction to 8.00 percent would increase the Plan's actuarial accrued liability by $143.8 million (or 5.0%), while a 7.50 percent rate would increase the Plan's liability by $300.8 million (or 10.5%).

A June 26, 2014 presentation to the Board notes that at the March 14, 2014 presentation, the Board requested the actuary develop projections using both an 8.50 percent and 8.25 percent investment return assumption. The June 26 presentation noted that reducing the rate of return assumption to 8.25 percent would not require an increase in employee and employer contribution rates to the Plan.

In a September 4, 2014 presentation to the Board, the Plan's actuary laid out several reasons why a rate of return lower than the current 8.50 percent should be considered. These reasons included:

- Achieving the 8.50 percent rate of return over the next 10 years will be more difficult; thus, in the short term, actuarial losses may be produced;

- The analysis of the OAG's actuary may not come to the same conclusion. The OAG actuary has consistently projected lower returns and the Auditor General can unilaterally change the assumptions used; and

- Reducing the rate of return to 8.25 percent has no impact on the 2015 contribution rates.

The September 4, 2014 presentation stated that "*While the analysis does <u>barely</u> support the continued use of the 8.50% return assumption, the continued use of the 8.50% return may give the appearance of using an assumption that "is legal" as opposed to an assumption that is both reasonable and contains an appropriate degree of conservatism.*" It also noted that reducing the return assumption is "in tune" with recent trends in the public plan sector.

The September 4 presentation recommended that the Board adopt the 8.25 percent investment return assumption. The presentation went on to recommend that in future

years the Board should consider assuming a lower rate of return assumption. At its September 25, 2014 meeting, the Board adopted the January 1, 2014 Actuarial Valuation which used the 8.25 percent rate of return assumption.

Comparison with Rates of Returns for Other Pension Plans

An investment return assumption of 8.25 percent is at the upper range of investment return assumptions for comparable plans. The Public Fund Survey includes data on 126 public pension plans. A year ago, there were 12 plans that reported an investment return assumption of 8.25 percent or higher in the Public Fund Survey's data online. In the Public Fund Survey's October 2014 online data, only 5 of the 126 plans used an investment return assumption of 8.25 percent or higher: two used an 8.50 percent return, while three others used an 8.25 percent rate. The median investment return assumption for the 126 plans reported in October 2014 Public Fund Survey data was 7.90 percent.

Wilshire Consulting's *2014 Report on State Retirement Systems: Funding Levels and Asset Allocation* examined the asset allocation and funding levels for 134 state retirement systems. Wilshire estimated that the median state pension fund has an expected return of 6.63 percent. This median expected return is lower than the current median actuarial interest rate assumption of 7.75 percent used by the plans in the study and is lower than the 8.25 percent assumption selected for the CTA Retirement Plan. This Wilshire report notes that Wilshire's assumptions range over a conservative 10+ year time horizon, while pension plan interest rate assumptions typically project over 20 to 30 years.

The National Conference on Public Employee Retirement Systems and Cobalt Community Research released the *2013 NCPERS Public Retirement System Study*. NCPERS is a trade association for public sector pension funds, representing more than 550 funds in the United States and Canada. The 2013 Study includes responses from 241 state, local, and provincial government pension funds with assets exceeding $1.4 trillion. According to the Study, the average investment return assumption was 7.60 percent in 2013, which was down 0.1 percent from 2012. The inflation assumption fell to 3.30 percent in 2013, down from 3.40 percent in 2012. Similar to the findings from the Public Fund Survey, the *2013 NCPERS Public Retirement System Study* found that there was increased activity over the 2012 study with respect to lowering the actuarial assumed rate of return.

Aon Hewitt Analysis

Actuarial Standard of Practice No. 27 (ASOP No. 27), effective for measurement dates on or after September 2014, provides guidance on the selection of economic assumptions for measuring pension obligations and dictates that "each economic assumption selected by the actuary should be reasonable," and should have "no

significant bias." It does recognize that "different actuaries will apply different professional judgment and may choose different reasonable assumptions. As a result, a range of reasonable assumptions may develop . . . across actuarial practice."

Using Aon Hewitt's Expected Return Tool (as of the 1st Quarter of 2014 with an inflation assumption of 2.30%) and the Target Asset Allocation found in the CTA Retirement Plan's Investment Performance Report for the Period Ending December 31, 2013, Aon Hewitt determined that the 35th to 65th percentile range of the CTA Retirement Plan's investment returns to be 8.15 percent to 6.38 percent, with the 50th percentile rate equal to 7.26 percent. The Retirement Plan's investment return assumption of 8.25 percent represented the 32nd or 33rd percentile in Aon Hewitt's tool, depending on whether the return is net of administrative expenses. If the Retirement Plan's inflation assumption of 3.25 percent is used (rather than Aon Hewitt's 2.30 percent), the Expected Return Tool generates a 35th to 65th percentile range of the CTA Retirement Plan's investment returns to be 8.87 percent to 7.11 percent, with the 50th percentile rate equal to 7.99 percent. The Retirement Plan's investment return assumption of 8.25 percent would then represent the 44th percentile in Aon Hewitt's tool. The Aon Hewitt Expected Return Tool calculates the expected portfolio growth rate (50th percentile, geometric return) before any value added from active management, and before any reduction for administrative expenses that are paid from the trust fund.

Historical Rates of Return Experienced by the Plan's Investments

Over the past 24 years, the rate of return on Retirement Plan investments has exceeded its current 8.25 percent assumed rate of return. Since 1990, the Plan's return on investments has averaged 8.90 percent, according to the Plan's 2012 Investment Performance Report. The Plan's Executive Director noted that at its October 23, 2014 meeting, the Board of Trustees adopted a new asset allocation which the investment advisor expected to obtain a total average annualized ten year return of 8.35 percent.

Conclusion: Investment Return Assumption

In the January 1, 2014 Actuarial Valuation, the Plan reduced its rate of return to 8.25 percent, down from 8.50 percent used in the previous three years' valuations. However, the 8.25 percent rate of return assumption remains at the upper end of rates of return used by other retirement plans in the United States. Historical rates of return experienced by the Retirement Plan on its investments have exceeded the 8.25 percent investment return assumption. Also, according to the Plan's Executive Director, the Plan's investment advisor expects the Plan's asset allocation to obtain a total average annualized ten year return of 8.35 percent. While the experience study conducted by the Plan's actuary projected that the 8.25 percent rate of return has a more than 50 percent chance of being realized over a 30 year period, the actuary also concluded that the Board should consider lowering it in future years.

Given that the Retirement Plan's investment return assumption remains at the upper range of returns used by other plans in the United States, and the Plan's actuary's recommendation that the Board consider lowering this assumption in future years, we recommend that the reasonableness of this assumption should be examined annually, rather than waiting until the next experience study, which will cover the period January 1, 2013 through December 31, 2017 and will be first used for the January 1, 2019 valuation.

Mortality Assumption

Actuarial Standard of Practice No. 35 (ASOP No. 35) was amended such that Section 3.5.3 has been revised to provide guidance with respect to mortality improvement before and after the measurement date. The revisions to ASOP No. 35 are effective for any actuarial valuation with a measurement date on or after June 30, 2011. After the 2013 experience study, the Plan adopted generational mortality tables to account for future mortality improvements. The Plan used the RP2000 Blue Collar Table, generational to 2016, based on Scale BB and then fully generational.

The Plan's new mortality assumption was chosen before the final RP-2014 and MP-2014 reports were issued by the Society of Actuaries (SOA). The new SOA reports state that it is not inappropriate for actuaries to consider one or more of the RP-2014 tables for public plan use. Aon Hewitt suggests that the Plan's mortality experience be reviewed again based on the new available tables. Consistent with the RP-2000 tables, the new RP-2014 tables are prepared on a benefits-weighted basis, and experience studies using these tables (either RP-2000 or RP-2014) should generally also be performed on a benefits-weighted basis, rather than a headcount-weighted basis. Not enough data was provided for Aon Hewitt to determine whether the Plan's most recent mortality study was performed on a benefits-weighted or headcount-weighted basis. However, since an RP-2000 table was adopted as a result of that study and since RP-2014 tables will also be considered in the future, we would expect next year's mortality analysis to be done on a benefits-weighted basis, and consider all of the available RP-2014 tables.

Active Participant Assumption

The decrease in active participants from 2013 to 2014 continues a trend that threatens to decrease the funded status of the Plan from its current 60.9 percent and improved projected 2039 rate. The Public Fund Survey Summary of Findings for FY 2012 states "When combined with an unfunded liability, however, a low or declining ratio of actives to annuitants can cause fiscal distress for pension plan sponsors…A lower ratio of actives to annuitants results in costs to amortize a plan's unfunded liability over a smaller payroll base, which increases the cost of the plan as a percentage of employee payroll."

In the January 1, 2014 Actuarial Valuation, the Plan's actuary has assumed a steady future level of active members through the projection period of 2044. To the

extent future participation differs from this assumption, the future contribution levels will be impacted. Although the assumption by the Plan's actuary in recent years has kept the active headcounts level, the active population has steadily decreased for years 2010 – 2014, declining from 9,865 in the 2010 Valuation to 8,186 in the 2014 Valuation.

Aon Hewitt noted that future contributions as a percentage of payroll may be required to increase if the constant headcount assumption is not met. The actuary noted that they "understand that Plan staff is working with the CTA to get a better understanding of the drivers relating to the drop in employee population."

Our Review last year noted that the Board may want the Plan's actuary to more fully examine the factors contributing to the decreasing number of participants and whether that trend is expected to continue. That information or analysis may prove useful to the Board in its consideration of the adequacy of current contribution rates to meet statutorily required funded ratios. In light of the continued decrease documented in the January 1, 2014 Actuarial Valuation, we recommend that the Plan evaluate this assumption for its continued reasonability. Such an evaluation could determine, for example, that it is appropriate to assume that headcount continues to decline for a certain number of years before it levels off.

Other Actuarial Assumptions

The 2014 experience study resulted in the Plan's actuary recommending other changes be made to the actuarial assumptions used by the Board. These updated assumptions included:

- **Rates of Retirement**: Retirement rates for participants with service over 25 years or over age 67 were modified.

- **Rates of Termination:** Termination rates were lowered.

- **Rates of Disability:** The suppression of rates for participants with service over 25 years used in prior valuations was removed.

- **Salary Increases:** Salary increases were reduced.

The Board approved these assumptions, along with the new investment return and mortality assumptions, for use beginning with the January 1, 2014 Actuarial Valuation. All the revised assumptions in the January 1, 2014 Actuarial Valuation increased the Plan's liability by $148,841,651. Of the $148,841,651, $71,866,056 was attributable to the reduction in the rate of return from 8.50 percent to 8.25 percent. The remaining $76,975,595 was attributable to the other assumptions that were revised.

Funded Ratio

The funded ratio of the Retirement Plan as of January 1, 2014 increased slightly from the prior year, increasing from 59.4 percent to 60.9 percent. The actuarial value of assets was $1.703 billion at January 1, 2013. At January 1, 2014, the actuarial value of assets was reported at $1.893 billion and the actuarial accrued liability was $3.106 billion.

The Illinois Pension Code (40 ILCS 5/22-101(e)(3)) contains specific requirements regarding the funded ratio of the CTA Retirement Plan. The Code states that:

> (3) . . . If the actual funded ratio declines below 60% in any year prior to 2040, the Board of Trustees shall also determine the increased contribution required each year as a level percentage of payroll during the years after the then current year using the projected unit credit actuarial cost method so the funded ratio is projected to reach at least 60% no later than 10 years after the then current year and include that determination in its report. . . .

The Pension Code requires the CTA to contribute 12 percent of pay, less up to a 6 percent credit for debt service paid on the bonds used to fund the Plan; employees are required to pay 6 percent of pay. If the funded ratio is projected to decline below 60 percent prior to 2040, the Pension Code requires the CTA to pay two-thirds and employees one-third of the required contribution.

The funded ratio of the Plan declined under 60 percent in the January 1, 2012 Actuarial Valuation. In 2012, the Retirement Plan increased the employer and employee contribution rates for 2013: the employer rate increased from 11.3 to 14.250 percent (which is net of the 6% credit given to the CTA for debt service on the pension obligation bonds sold in 2008); the employee rate increased from 8.65 to 10.125 percent. The contribution rates approved by the Board of Trustees for 2014 and 2015 were unchanged from 2013. Since the funded ratio rose above 60 percent (60.9%), instead of decreasing to 59.00 percent as projected in the 2013 Valuation, there was no need to increase the employer and employee contribution rates for 2015 to comply with the minimum requirements of the Pension Code. However, the Plan's actuary noted that should market losses result in a decline in the Plan's assets, then increased employee and employer contributions would be required in future years.

According to the January 1, 2014 Actuarial Valuation, the rates that were adopted were slightly higher than the required minimum contribution rates to meet the Pension Code's funding requirements. The minimum rates needed to meet the Pension Code requirements were 13.232 percent for the CTA (which is net of the 6% credit for debt service) and 9.616 percent for employees, according to the Plan's actuary.

The January 1, 2014 Actuarial Valuation notes that differences between the expected experience based on the actuarial assumptions and the actual experience create changes in the actuarial accrued liability, the actuarial value of assets, and the unfunded

actuarial accrued liability from one year to the next. These changes create an actuarial gain if the experience is favorable, and an actuarial loss if the experience is unfavorable. The Plan experienced a total net actuarial gain of $113.2 million during 2013.

The January 1, 2014 Actuarial Valuation details the factors contributing to the net actuarial gain. Even though the Plan's demographic assumptions (such as mortality, turnover, retirement, pay increases, etc.) experienced a loss of $40.9 million during 2013, this was more than offset by a gain of $154.1 million on the actuarial value of assets. This was attributable to the Plan's assets realizing an actual rate of return on assets of 19.5 percent in 2013, as compared to the assumption of 8.50 percent.

The January 1, 2014 Actuarial Valuation projects the funded ratio of the Plan to be 97.41 percent in year 2039. This is an increase from last year's projected funded ratio in year 2039 of 88.95 percent.

Funding Policy: Pension Code v. GASB 25

The January 1, 2014 Valuation discloses that the contribution rates contained in the Valuation were determined in accordance with the requirements of the Pension Code, which differ from the funding policy suggested by Governmental Accounting Standards Board Statement Number 25 (GASB 25). According to the Valuation, GASB 25 suggests a funding policy sufficient to pay the normal cost and amortize the unfunded actuarial accrued liability over a fixed period of 30 years. The actuary noted in its September 25, 2014 presentation to the Board that under the current Pension Code requirements, the funded status remains relatively flat for the next decade before noticeably improving. It goes on to state that a preferred actuarially accepted funding policy would improve the funded status each year by 1 or 2 percent, until the Plan was 100 percent funded in 2040.

The Plan's actuary recommended that the Board of Trustees consider, as appropriate, moving towards a contribution of the annual required contribution (ARC), as delineated in GASB 25, over the next several years.

SCOPE OF ANNUAL REVIEW

The Office of the Auditor General conducted an annual review of information submitted by the Retirement Plan pursuant to the Illinois State Auditing Act and the Illinois Pension Code. This report does not constitute an audit as that term is defined in generally accepted government auditing standards. Consequently, while we reviewed the information provided by the CTA Retirement Plan for reasonableness and consistency, we did not conduct an audit of the accuracy of the information provided as that is the responsibility of the Plan.

The scope of our work included reviewing the information submitted by the Retirement Board on September 30, 2014. This information included: the Audited Financial Statements for the Plan for the year ended December 31, 2013; the Investment Performance Report for the period ending December 31, 2013; and the January 1, 2014 Actuarial Valuation for the Retirement Plan. We conducted follow-up with the Retirement Plan on various questions we had based upon our review of these documents.

Our consultants, Aon Hewitt, reviewed the reasonableness of the actuarial assumptions used by the CTA Retirement Plan in their January 1, 2014 Actuarial Valuation.

We inquired of the Plan whether there were any pending court proceedings that may have a significant impact on the funding of the Plan. The Executive Director responded that the *Matthews* case, which is before the Illinois Supreme Court, could have a significant impact on either the Retirement Plan or the Retiree Health Care Trust, in the magnitude of $100 million or more. The plaintiffs in the *Matthews* case are current and former employees of the CTA who argue that after years of fully paid health care benefits for retired CTA employees, they are now being asked to pay for a portion of their health care benefits and are no longer entitled to the same level of health care coverage as active CTA employees. The changes to their coverage occurred as a result of an arbitration award and related amendments to the Pension Code made by Public Act 95-708.

We received minutes of the Retirement Plan Board meetings for the period September 2013 through September 2014. In our 2011 Review, we noted that the Retirement Board approved a payroll audit in 2011. The Board's Executive Director expected the audit to be completed by the end of 2012. The purpose of the audit is to ensure that the employers are accurately withholding and remitting employee and employer contributions to the Retirement Plan and Retiree Health Care Trust. The Executive Director stated a draft report was provided to the Trustees of the Retirement Plan in December 2013. The Trustees set a deadline of January 17, 2014 for comments by the remitting employers (the CTA and Local Unions 241 and 308). The Board appointed a subcommittee to consider issues relating to the draft reports and comments received. The subcommittee for the Retirement Plan met several times during 2014 and requested additional information from the parties. At the Board meeting in September 2014, the Retirement Plan Trustees voted to have an arbitrator selected to address certain issues related to the audit.

The OAG performed this Review with assistance from our consultants, Aon Hewitt. Aon Hewitt's review concluded that:

(A) The required documents submitted by the Board of Trustees of the Retirement Plan have been made, and meet the statutory requirements of Section 5/3-2.3(e)(1), (2), and (3) of the Auditing Act.

(B) The assumptions stated in the actuarial report submitted pursuant to 40 ILCS 5/22-101(e)(3) are not unreasonable in the aggregate. However, we believe three of the

assumptions warrant additional scrutiny, and we'd like to see additional support and/or analysis for these assumptions prior to next year's valuation. The three assumptions are investment return, mortality, and the number of active participants in future years.

(C) 40 ILCS 5/22-101(e)(3) indicates that if the Plan's funded ratio is projected to fall below 60% in any year before 2040, minimum contribution rates are to be determined on a level percentage of payroll basis over the years remaining until 2040 that keep the projected funded ratio above 60% in all years through 2039, based on assumptions which are not unreasonable in the aggregate. 40 ILCS 5/22-101(e)(3) also indicates that if the actual funded ratio declines below 60% in any year prior to 2040, the actuarial report shall also show an increased contribution rate that is determined on a level percentage of payroll basis during the years after the current year such that the funded ratio is projected to reach at least 60% no later than 10 years after the then current year. The funded ratio first fell below 60% for the 2012 plan year. The projections indicate that the contribution rates adopted for 2013 of 10.125% for employees and 14.250% for the employer (with the 6% credit for debt service) were intended to bring the funded status to 60% (or higher) by 2022 (i.e. 10 years after the implementation year). The funded status in 2014 rose to 60.95% instead of decreasing to 59.00% as projected in the 2013 valuation, and therefore there is no need at this time to further increase employer and employee contribution rates to comply with 40 ILCS 5/22 – 101(e).

(D) The requirement to keep the projected funded ratio above 60% is not a Governmental Accounting Standards Board ("GASB") approved funding method. GASB Statement No 25 (GASB25) defines the Annual Required Contribution (ARC) to be the employer's normal cost plus an amortization payment of the unfunded actuarial accrued liability. Employer normal cost is the excess of the Plan's total normal cost (portion of the Plan's present value of benefits allocated to the current year), over the amount of employee contributions. Actuarial accrued liability is the cost of the benefits allocated to service prior to the current year. The unfunded actuarial accrued liability is the difference between the actuarial accrued liability and the actuarial value of assets. The maximum amortization period for the unfunded actuarial accrued liability is 30 years under GASB25. Under GASB25, the Annual Required Contribution funds to 100%. Page 26 of the Actuarial Report provides a comparison of the actual contributions made by the CTA for the past 10 years to the Annual Required Contribution as determined under GASB25. In all years, other than 2008 when the pension obligation bond was purchased, the actual contributions received from the CTA were less than the Annual Required Contribution under GASB25.

The Retirement Plan was provided a draft of this report for its review.

APPENDIX A
Statutory Authority

ILLINOIS STATE AUDITING ACT

30 ILCS 5/3-2.3(e) and (f)

(e) Annual Retirement Plan Submission to Auditor General. The Board of Trustees of the Retirement Plan for Chicago Transit Authority Employees established by Section 22-101 of the Illinois Pension Code shall provide the following documents to the Auditor General annually no later than September 30:

(1) the most recent audit or examination of the Retirement Plan;

(2) an annual statement containing the information specified in Section 1A-109 of the Illinois Pension Code; and

(3) a complete actuarial statement applicable to the prior plan year, which may be the annual report of an enrolled actuary retained by the Retirement Plan specified in Section 22-101(e) of the Illinois Pension Code.

The Auditor General shall annually examine the information provided pursuant to this subsection and shall submit a report of the analysis thereof to the General Assembly, including the report specified in Section 22-101(e) of the Illinois Pension Code.

(f) The Auditor General shall annually examine the information submitted pursuant to Section 22-101B(b)(3)(iii) of the Illinois Pension Code and shall prepare the determination specified in Section 22-101B(b)(3)(iv) of the Illinois Pension Code.

(Source: P.A. 95-708, eff. 1-18-08.)

ILLINOIS PENSION CODE

40 ILCS 5/1A-109

Annual statements by pension funds. Each pension fund shall furnish to the Division an annual statement in a format prepared by the Division. The Division shall design the form and prescribe the content of the annual statement and, at least 60 days prior to the filing date, shall furnish the form to each pension fund for completion. The annual statement shall be prepared by each fund, properly certified by its officers, and submitted to the Division within 6 months following the close of the fiscal year of the pension fund.

The annual statement shall include, but need not be limited to, the following:

(1) a financial balance sheet as of the close of the fiscal year;

(2) a statement of income and expenditures;

(3) an actuarial balance sheet;

(4) statistical data reflecting age, service, and salary characteristics concerning all participants;

(5) special facts concerning disability or other claims;

(6) details on investment transactions that occurred during the fiscal year covered by the report;

(7) details on administrative expenses; and

(8) such other supporting data and schedules as in the judgement of the Division may be necessary for a proper appraisal of the financial condition of the pension fund and the results of its operations. The annual statement shall also specify the actuarial and interest tables used in the operation of the pension fund.

(Source: P.A. 90-507, eff. 8-22-97.)

40 ILCS 5/22-101

Sec. 22-101(e). Retirement Plan for Chicago Transit Authority Employees.

(1) Beginning January 1, 2009 the Authority shall make contributions to the Retirement Plan in an amount equal to twelve percent (12%) of compensation and participating employees shall make contributions to the Retirement Plan in an amount equal to six percent (6%) of compensation. These contributions may be paid by the Authority and participating employees on a payroll or other periodic basis, but shall in any case be paid to the Retirement Plan at least monthly.

(2) For the period ending December 31, 2040, the amount paid by the Authority in any year with respect to debt service on bonds issued for the purposes of funding a contribution to the Retirement Plan under Section 12c of the Metropolitan Transit Authority Act, other than debt service paid with the proceeds of bonds or notes issued by the Authority for any year after calendar year 2008, shall be treated as a credit against the amount of required contribution to the Retirement Plan by the Authority under subsection (e)(1) for the following year up to an amount not to exceed 6% of compensation paid by the Authority in that following year.

(3) By September 15 of each year beginning in 2009 and ending on December 31, 2039, on the basis of a report prepared by an enrolled actuary retained by the Plan, the Board of Trustees of the Retirement Plan shall determine the estimated funded ratio of the total assets of the Retirement Plan to its total actuarially determined liabilities. A report containing that determination and the actuarial assumptions on which it is based shall be filed with the Authority, the representatives of its participating employees, the Auditor General of the State of Illinois, and the Regional Transportation Authority. If the funded ratio is projected to decline below 60% in any year before 2040, the Board of Trustees shall also determine the increased contribution required

each year as a level percentage of payroll over the years remaining until 2040 using the projected unit credit actuarial cost method so the funded ratio does not decline below 60% and include that determination in its report. If the actual funded ratio declines below 60% in any year prior to 2040, the Board of Trustees shall also determine the increased contribution required each year as a level percentage of payroll during the years after the then current year using the projected unit credit actuarial cost method so the funded ratio is projected to reach at least 60% no later than 10 years after the then current year and include that determination in its report. Within 60 days after receiving the report, the Auditor General shall review the determination and the assumptions on which it is based, and if he finds that the determination and the assumptions on which it is based are unreasonable in the aggregate, he shall issue a new determination of the funded ratio, the assumptions on which it is based and the increased contribution required each year as a level percentage of payroll over the years remaining until 2040 using the projected unit credit actuarial cost method so the funded ratio does not decline below 60%, or, in the event of an actual decline below 60%, so the funded ratio is projected to reach 60% by no later than 10 years after the then current year. If the Board of Trustees or the Auditor General determine that an increased contribution is required to meet the funded ratio required by the subsection, effective January 1 following the determination or 30 days after such determination, whichever is later, one-third of the increased contribution shall be paid by participating employees and two-thirds by the Authority, in addition to the contributions required by this subsection (1).

(4) For the period beginning 2040, the minimum contribution to the Retirement Plan for each fiscal year shall be an amount determined by the Board of Trustees of the Retirement Plan to be sufficient to bring the total assets of the Retirement Plan up to 90% of its total actuarial liabilities by the end of 2059. Participating employees shall be responsible for one-third of the required contribution and the Authority shall be responsible for two-thirds of the required contribution. In making these determinations, the Board of Trustees shall calculate the required contribution each year as a level percentage of payroll over the years remaining to and including fiscal year 2059 using the projected unit credit actuarial cost method. A report containing that determination and the actuarial assumptions on which it is based shall be filed by September 15 of each year with the Authority, the representatives of its participating employees, the Auditor General of the State of Illinois and the Regional Transportation Authority. If the funded ratio is projected to fail to reach 90% by December 31, 2059, the Board of Trustees shall also determine the increased contribution required each year as a level percentage of payroll over the years remaining until December 31, 2059 using the projected unit credit actuarial cost method so the funded ratio will meet 90% by December 31, 2059 and include that determination in its report. Within 60 days after receiving the report, the Auditor General shall review the determination and the assumptions on which it is based and if he finds that the determination and the assumptions on which it is based are unreasonable in the aggregate, he shall issue a new determination of the funded ratio, the assumptions on which it is based and the increased contribution required each year as a level percentage of payroll over the years remaining until December 31, 2059 using the projected unit credit actuarial cost method so the funded ratio reaches no less than 90% by December 31, 2059. If the Board of Trustees or the Auditor General determine that an increased contribution is required to meet the funded ratio required by this subsection, effective January 1 following the determination or 30 days after such determination, whichever is later, one-third of the increased contribution shall be paid by participating employees and two-thirds by the Authority, in addition to the contributions required by subsection (e)(1).

(5) Beginning in 2060, the minimum contribution for each year shall be the amount needed to maintain the total assets of the Retirement Plan at 90% of the total actuarial liabilities of the Plan, and the contribution shall be funded two-thirds by the Authority and one-third by the participating employees in accordance with this subsection.

(Source: P.A. 95-708, eff. 1-18-08, P.A. 97-442, eff. 8-19-11; P.A. 97-609, eff. 1-1-12; P.A. 97-813, eff. 7-13-12.)