Illinois to bolster state pension with new borrowing—Again

By Editor Test *Wed, Feb 23, 2011*

A similar strategy backfired in 2003, when the state tried to fund its pension by borrowing $10 billion at 5.1%. It earned 3% on the proceeds, instead of the promised 8%.

Already heavily in debt, the state of Illinois hopes to borrow an additional $3.7 billion this year to make its annual contribution to the state pension fund. The prospect has made municipal bond markets nervous and sparked an investigation into whether Illinois has hidden the risks that the pension fund poses, according to news reports.

Illinois was initially scheduled to sell the bonds on February 17. But on the 21st, the sale was pushed back until next week, state officials said, so the bond markets, and overseas investors, would have more time to digest Governor Pat Quinn's budget address on Wednesday.

A similar strategy backfired in 2003, when the state tried to replenish its pension fund by borrowing $10 billion at 5.1% and reinvesting the money. But the money earned only 3%, not the projected 8%, and the ensuing scandal led to the indictment of former Governor Rod Blagojevich and several associates on influence-peddling charges.

This time it's different, say state officials.

"The bonds we're talking about issuing next week are not meant to do what the 2003 bonds did, so the rate of return the portfolio of the pension funds earn is not relevant to this discussion," said one official. Rather than seek high returns, he said, "the pension bonds we're issuing next week are simply for this year's contribution. There is no attempt at arbitrage."

On the new bond issue, Illinois' lead underwriters are Morgan Stanley, Goldman Sachs and Loop Capital Markets; 11 other underwriters will sell smaller portions. A local firm, Peralta Garcia Solutions, is advising the state, and three law firms are also involved.

The bond prospectus explains the troubled history of Illinois's pension system, revealing that that the bonds issued in 2003 called for the state to reduce its annual contributions to the pension fund and use the money instead to pay the bondholders their interest.

Those diversions, plus enormous investment losses in 2008 and 2009, left the pension fund with a shortfall of about $86 billion, or roughly twice the shortfall before the 2003 bonds were issued.

"That pension plan has been consistently abused now for at least the last 16 or 17 years," said Brad M. Smith, president-elect of the Society of Actuaries and chairman of Milliman. He called the state's schedule of pension contributions for the coming years "incredibly dangerous," adding: "There's a reasonable chance that these plans will run out of money."

A 1994 state law, Smith noted, permits Illinois to contribute less to the pension fund every year than the amount that would actually cover the benefits. Adding new bond proceeds will not address that basic flaw, which investigators now say was based on an accepted actuarial method.