EXECUTIVE SUMMARY

REVIEW OF DOCUMENTS RELATED TO THE PROPOSED SALE OF BONDS FOR THE CHICAGO TRANSIT AUTHORITY RETIREMENT PLAN AND RETIREE HEALTH CARE TRUST

Conducted Pursuant to
30 ILCS 5/3-2.3
(Public Act 95-708)

Released: July 2008

State of Illinois
Office of the Auditor General

WILLIAM G. HOLLAND
AUDITOR GENERAL

To obtain a copy of the Report contact:
Office of the Auditor General
Iles Park Plaza
740 E. Ash Street
Springfield, IL 62703
(217) 782-6046 or TTY (888) 261-2887

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This report examines the information submitted by the Chicago Transit Authority (CTA), the Board of Trustees of the Retirement Plan for CTA Employees, and the Board of Trustees of the Retiree Health Care Trust pursuant to Section 3-2.3(a) of the Illinois State Auditing Act. Our review was related to the proposed sale of bonds for the CTA's Retirement Plan and the Retiree Health Care Trust, as required by Sections 3-2.3(b) and (c) of the Illinois State Auditing Act as amended by Public Act 95-708.

This report concludes that the information submitted to the Office of the Auditor General complied with the statutory requirements. Our responsibilities were limited to the specific conclusions required by 30 ILCS 5/3-2.3(b) and (c). This report does not constitute an audit as that term is defined in generally accepted government auditing standards.

A summary of our report, prepared by Aon Consulting, is presented below.

1. **NEW LAW**
   Public Act 95-708 (the Act), effective January 18, 2008, required the Office of the Auditor General (OAG) to examine limited and specific information from the CTA regarding issuing bonds to provide funding for the CTA Retirement Plan and the Retiree Health Care Trust.

2. **REQUIREMENTS**
   The Act required the OAG to determine if the CTA provided the OAG with specific certifications and actuarial reports, whether the reports contained all the required information, whether the assumptions were "*not unreasonable in the aggregate,*" and whether the reports appeared to comply with all professional standards. The Act provided us 60 days to review CTA's submission. CTA submitted the documents required on May 19, 2008.

3. **FUNDING**
   After our report indicates compliance with the Act, CTA may sell bonds within 120 days, with net deposits of $1.11 billion for the Retirement Plan and nearly $529 million for the Retiree Health Care Trust.

4. **PURPOSE**

Pension obligation bonds (POB) have been considered by several government entities in the past two decades as a potential solution to under-funded retirement systems. The POB transaction is essentially borrowing in the debt market for investment in a pension fund which is invested in both debt and equities. If the net investment return from the pension fund exceeds the net borrowing costs, the transaction will have resulted in cost savings. But if the net investment return does not exceed the borrowing cost, the POB transaction will not have resulted in cost savings.

5. **BONDS**

As of the January 1, 2007 actuarial valuation, the ratio of Retirement Plan assets to actuarial liabilities was 30 percent. At this time, the Retirement Plan liabilities included the health care liabilities which are to be transferred to the Retiree Health Care Trust. The actuarial report by CTA's Retirement Plan actuary, Gabriel, Roeder, Smith and Company (GRS), indicated that bond sales will increase the Retirement Plan's funding to more than 80 percent in 2009.

6. **MEDIAN RETURN**

The median investment return assumption for public retirement systems is 8.00 percent and the median inflation assumption is 3.50 percent for a real rate of return of 4.50 percent, according to the 2007 Public Fund Survey sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement.

7. **RATE OF RETURN**

GRS' initial analysis was based on actuarial investment return assumptions of 9.00 percent and 8.75 percent. GRS calculated that there was only a 28 percent chance of achieving the 9.00 percent annual rate of return and a 30 percent chance of earning an 8.75 percent annual rate of return.

- We concluded it was important to consider outcomes which did not fall into the 30 percent most favorable investment return outcomes. On May 29, 2008, we asked GRS to also project its median investment return for the Retirement Plan (7.70%) and its return that would cover the cost of the bonds (approximately 6.00%). GRS added these cost projections to its report along with the likelihood (probability) of achieving the returns (see Exhibit 1).

- GRS used an inflation assumption of 3.25 percent, meaning the real rate of return is expected to be 5.50 percent, assuming an 8.75 percent rate of return. CTA's Retiree Health Care Trust actuary, the Segal Company, estimated a 7.00 percent rate of return. Using a lower return assumption is generally accepted practice for a health care trust which is not significantly funded and will have a shorter time horizon on its investments.

Exhibit 1 COST SAVINGS AT DIFFERENT RATES OF RETURN				
		32 Year Present Value Cost Savings		
1	2	3	4	5
Investment Return	**Likelihood Of This Level (Or Higher) Return[1]**	**Savings (Loss) From Bond Transaction For CTA**	**Savings From Bond Transaction For CTA Employees**	**Total Savings (Loss) From Bond Transaction**
8.75%	30%	$61.3 million	$202.0 million	$263.3 million
7.70%	50%	($12.4 million)	$165.1 million	$152.7 million
6.00%	82%	($125.1 million)	$108.7 million	($16.4 million)

[1] Likelihood that assets earn at least the assumed return.
Source: Gabriel, Roeder, Smith & Company Actuarial Valuation under Public Act 95-708 relating to the Retirement Plan, June 4, 2008, p. 30.

8. **POTENTIAL COST SAVINGS**
Exhibit 1 shows in Column 3 that the 32-year present value of cost savings of $61 million would accrue to the CTA if the average annual rate of return is 8.75 percent for the Retirement Plan; CTA would lose over $12 million if the average rate of return is 7.70 percent and $125 million if the rate of return is 6.00 percent. Column 4 shows the 32-year present value cost savings would accrue to CTA employees of approximately $100 million to $200 million at these three different rates of return.

9. **RETIREE HEALTH CARE TRUST**
The Segal Company performed their actuarial modeling assuming that the medical and pharmacy inflation rate would be 10 percent for 2008 and the ultimate trend rate would become 5 percent per year, consistent with other plans. However, it should be noted that a recent study from the Society of Actuaries has projected higher long-term trend rates. There is a risk that medical inflation will decrease at a slower rate than assumed, which would result in actuarial losses in future years when this liability is revalued.

10. **BOND INTEREST RATE**
The GRS analysis assumed a borrowing cost of approximately 5.95 percent (and the Segal Company assumed 6.1%). If financial markets change, the projected savings from the bond issuance will also change.

WILLIAM G. HOLLAND, Auditor General

WGH:AD
July 2008

CONTRACTUAL ASSISTANCE

Aon Consulting provided contractual assistance in this review.