Illinois Municipal Retirement Fund

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GENERAL MEMORANDUM

Number: 514

Date: January 30, 2004

To: All Authorized Agents

Subject: Impact of 2003 Investment Return on Employer Reserves, Employer Funding Status, and Future Employer Contribution Rates

We encourage each Authorized Agent to share this memorandum with your unit of government's chief financial officer, other officials, and governing body members.

Executive Summary

The estimated 2003 investment return for IMRF is 22.5%. This return translates into investment income of approximately $3 billion. The $3 billion of investment income is the most IMRF has earned in its history.

IMRF's returns on a market basis for the 2002-1999 period were -8.7%, -6.1%, 1.9% and 20.9%. While IMRF earned 22.5% on a market basis in 2003, its *actuarial* return—the return that impacts employer contribution rates—was only 5%, less than the actuarial investment return assumption of 7.5%.

The difference between the market return of 22.5% and the actuarial return of 5% is due to IMRF using a five-year averaging technique for investment returns. We use five-year averaging to minimize large annual fluctuations in employer contribution rates.

Background

As a defined benefit plan, investment return fluctuations have no impact on the benefits of active or retired IMRF members. All member benefits are guaranteed. Also, as a defined benefit plan, IMRF is designed to be pre-funded. The lump sum needed to pay a lifetime pension should be available when an employee retires. This differs from "pay-as-you-go" plans—like Social Security—where money collected today is used to pay benefits owed to current retirees.

While investment return fluctuations do not impact member benefits, they do impact individual employer reserve balances, funding status, and contribution rates. IMRF, as a defined benefit plan, is designed to be 100% funded. The Illinois Pension Code [40 ILCS 5/7-172(b)(2)] requires the amortization of any unfunded liabilities over the remainder of the period allowable under generally accepted accounting principles.

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Investment Returns

As noted above, IMRF's estimated 2003 investment return on a *market basis* is 22.5%. However, for actuarial purposes, IMRF uses a common pension industry technique of five-year averaging of actual market returns to arrive at the *actuarial* return. The actuarial return is used to determine employer contribution rates and actuarial funding status. The five-year averaging technique, which is employed to moderate fluctuations in employer contribution rates, delays the recognition of both market gains and losses.

IMRF began 2003 with $3.3 billion of unrecognized investment losses. For 2003, IMRF will adjust its assumed investment income of $1,256 million (a 7.5% return on the January 1, 2003, actuarial value of IMRF investments) by 20% of the difference between the actual investment return and assumed investment return for each year in the 1999-2003 period.

Thus, on an actuarial basis IMRF's investment return for 2003 will be approximately $848 million. Due to the five-year averaging technique discussed above, as of December 31, 2003, IMRF still has $1.2 billion of unrecognized investment losses that will impact employer rates beyond 2005.

Impact on Employers

Employer Reserves - By statute, IMRF must credit approximately $661 million to member and retiree reserves. After providing these credits and covering administrative and direct investment expenses, approximately $2.4 billion will be credited to employer reserve balances. Approximately $334 million will be credited at 7.5% on beginning of the year positive employer reserve balances. The remaining amount of approximately $2,059 million will be distributed to all employers as residual investment income.

In total, employers will receive a credit of approximately 52% based on the beginning of the year balance. The additional residual income return beyond the normal 7.5% interest credit reflects the fact that, as sponsors of a defined benefit plan, IMRF employers bear all the risks and rewards of investment returns.

In 2003, IMRF employers will receive a significant financial benefit, just as last year there was a significant charge.

Employer Funding Status - IMRF's 2003 overall funded status on an actuarial basis is expected to decline from 101.5% as of year-end 2002 to 98.8% at year-end 2003. This decrease is due to IMRF's recognized actuarial return of 5% being less than its assumed actuarial return of 7.5%.

However, on a market value basis (which does not reflect the five-year averaging technique), IMRF's funded status is projected to increase from 81.5% as of year-end 2002 to 92.1% at year-end 2003. The 92.1% reflects the 22.5% market return in 2003.

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Most individual employers can expect that their funded status on an actuarial basis has declined, while their funded status on a market basis has improved. In April, we will furnish each employer its annual GASB 27 footnote information which will disclose both.

Employer Contribution Rates – Employer contribution rates consist of as many as six parts: normal retirement costs, death in service benefits, temporary disability benefits, supplemental retirement benefits (13th check), amortization of over or under funding, and early retirement incentives (employer option).

The ongoing cost of the IMRF benefit package for the Regular plan covering normal retirement costs, death in service benefits, temporary disability benefits and supplemental retirement benefits equals 8.6% of payroll. Put another way, for each dollar of service a member renders, the employer also incurs a liability of 8.6 cents. To the extent that an employer was overfunded, the 8.6 cents was reduced to amortize its surplus.

The average employer rate for the Regular plan has been below 8.6% since 1999. Prior to 2000, one would have to go back to 1988 (when IMRF's benefit structure and actuarial experience were different than today) to find an average employer rate lower than 2004's average rate of 7.82%.

The impact of 2003 investment returns on individual employer contribution rates is difficult to forecast since each employer has a unique rate affected by its own demographics and funded status. As noted above, for rate setting purposes IMRF began 2003 with $3.3 billion of unrecognized investment losses. These losses were a result of the difficult financial markets in 2000, 2001 and 2002. Despite the tremendous returns for 2003, IMRF expects to still have $1.2 billion of unrecognized investment losses at year-end. If IMRF were able to consistently earn a market return of 7.5%—no more and no less—the average rate for the Regular plan would continue to increase until 2008 when it would peak at 10.53%.

The average employer rate for the Regular plan was 6.22% for 2003 and will be 7.82% for 2004, an increase of 160 basis points or 26%. A rough estimate of the average employer contribution for the Regular plan for 2005 is 8.52%, an increase of 70 basis points or 9%.

The impact on individual employers will vary widely. As individual employers' overfunding is depleted, there will be non-proportional rate increases not factored into the estimated average rate for 2005.

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IMRF Meetings

In order to discuss the potential impact on individual employers in 2005 and beyond as well as the underlying concepts driving reserve balances, funding levels, and contribution rates, IMRF will schedule a series of meetings throughout the state to answer any specific questions you or any other representatives of your employer might have.

The dates and locations will be provided in a subsequent General Memorandum. The meetings will be held after you receive your 2004 Advance Rate Notice. IMRF will mail the Advance Rate Notices in early April 2004.

Questions

If you have any questions regarding the information presented in this memo, please call 1-800-ASK-IMRF (1-800-275-4673) and ask for IMRF Chief Financial Officer Richard DeCleene.

Sincerely,

Louis W. Kosiba
Executive Director