Illinois Municipal Retirement Fund

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GENERAL MEMORANDUM

Number: 542

Date: February 15, 2006

To: All Authorized Agents

Subject: Impact of 2005 Investment Return on Employer Reserves, Employer Funding Status, and Future Employer Contribution Rates

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

Executive Summary

The estimated 2005 investment return for IMRF is 8.7%. This return translates into investment income of approximately $1.6 billion.

IMRF's returns for the 2005-2001 period were 8.7%,12.1%, 22.6%, -8.7%, and -6.1%. While IMRF earned 8.7% on a *market* basis in 2005, its *actuarial* return, which is the return that impacts employer contribution rates, was only 7.7%. This is slightly higher than the actuarial investment return assumption of 7.5%.

The difference between the market return of 8.7% and the actuarial return of 7.7% is due to IMRF's use of a five-year averaging technique for investment returns. Using a five-year averaging technique minimizes 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. 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.

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Since IMRF, as a defined benefit plan, is designed to be 100% funded, the Illinois Pension Code [40 ILCS-7-172(b)(2)] requires the amortization of any unfunded liabilities over the remainder of the period allowable under generally accepted accounting principles.

Investment Returns

As noted above, IMRF's estimated 2005 investment return on a market basis is 8.7%. 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. This averaging technique, which is employed to moderate fluctuations in employer contribution rates, delays the recognition of both market gains and losses.

For 2005, IMRF will be adjusting its assumed investment income of $1,374 million (a 7.5% return on the beginning of the year actuarial value of IMRF investments) by one-fifth of the excess of the market value return over the actuarial return.

Thus, for actuarial purposes, IMRF's investment return will be approximately $1,405 million. IMRF will begin 2006 with $124 million of unrecognized gains for actuarial rate-setting purposes, which will be recognized over the next four years.

Impact on Employer Reserves

By statute, IMRF must credit approximately $784 million to member and retiree reserves. After providing for these credits and covering administrative and direct investment expenses, approximately $752 million will be credited to employer reserve balances. Approximately $564 million will be credited at 7.5% on beginning of the year positive employer reserve balances. The remaining amount of approximately $188 million will be distributed to all employers as residual investment income.

On average, employers will receive a credit of approximately 9.8% 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 a member of a defined benefit plan, IMRF employers share all the risks and rewards of investment returns.

IMRF employers have received significant financial benefits over the last three years—$188 million in 2005, $814 million in 2004, and $2,060 million in 2003.

Employer Funding Status

IMRF's 2005 overall funded status on an actuarial basis is expected to increase slightly from 94.3% as of year-end 2004 to 94.4% at year-end 2005. This increase is due to the fact that on an *actuarial* basis IMRF earned more than its assumed 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 94.3% to 95.0% which reflects the 8.7% market return in 2005.

Most individual employers can expect that the funded status of the Regular plan will remain stable or improve modestly on an actuarial basis while their funded status on a market basis will improve slightly.

Due to P.A. 94-712, which improved the benefits for Sheriff's Law Enforcement Personnel (SLEP), the funded status of SLEP plans is expected to decline on both an actuarial and market basis.

In April, we will furnish each employer its annual GASB 27 footnote information which will disclose the actuarial and market value funded status for all plans.

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, is 8.70% of payroll in 2006. Put another way, for each dollar of service an employee renders, the employer also incurs a pension cost of 8.7 cents. To the extent that an employer was overfunded, the 8.7 cents was reduced to amortize its surplus.

The average employer rate for the Regular plan for 2006 is 10.04% and reflects the fact that the Regular plan is currently less than 100% funded.

The impact of 2005 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. Since IMRF's actuarial return was 7.7% in 2005, more than the 7.5% assumed return, the average employer rate for the Regular plan is expected to decrease to 9.97% in 2007. If IMRF is able to earn a market return of 7.5% or more in 2006, the average rate for the Regular plan will continue to decrease for 2008.

The average employer rate for the Regular plan was 9.25% for 2005 and will be 10.04% for 2006, an increase of 79 basis points or 10%. A rough estimate of the average employer contribution for the Regular plan for 2007 is 9.97%, a *decrease* of 7 basis points, or .6%.

At this time we are unable to estimate the impact on SLEP rates for 2007 due to P.A. 94-712, except to say that SLEP employers can expect an increase in their SLEP rate.

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 2007.

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IMRF Meetings

In order to discuss the potential impact on individual employers in 2007 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. These meetings will give IMRF the opportunity to answer any specific questions you or any other representatives of your unit of government might have.

These meetings will also provide an opportunity for IMRF to discuss certain initiatives and other matters that are taking place at your retirement plan. The dates and locations will be provided in a subsequent General Memorandum. The meetings will be held after you receive your 2007 Advance Rate Notice. IMRF will mail the Advance Rate Notices in early April 2006.

Questions

If you have any questions regarding the information presented in this memorandum, 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