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GENERAL MEMORANDUM

Number: 527

Date: February 2, 2005

To: All Authorized Agents

Subject: Impact of 2004 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 2004 investment return for IMRF is 12.1%. This return translates into investment income of approximately $2 billion, which is the third highest amount in IMRF's history. IMRF's returns for the 2004-2000 period were 12.1%, 22.6%, -8.72%, -6.1%, and 1.9%. While IMRF earned 12.1% on a market basis in 2004, its actuarial return—the return that impacts employer contribution rates—was only 4.6%, which is less than the actuarial investment return assumption of 7.5%. The difference between the market return of 12.1% and the actuarial return of 4.6% is due to IMRF's use of a five-year averaging technique for investment returns. The goal of the five-year averaging technique is 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. While investment return fluctuations do not impact member benefits, they do impact individual employer reserve balances, funding status, and contribution rates.

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 to current retirees.

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

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Investment Returns

As noted above, IMRF's estimated 2004 investment return on a market basis is 12.1%. 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 minimize fluctuations in employer contribution rates, delays the recognition of both market gains and losses. IMRF began 2004 with $1.2 billion of unrecognized investment losses. For 2004, IMRF will be adjusting its assumed investment income of $1,313 million (a 7.5% return on the beginning of the year actuarial value of IMRF investments) by the net unrecognized investment losses for the 2000-2004 period. Thus for actuarial purposes, IMRF's 2004 investment return will be approximately $799 million.

Since all net unrecognized losses will have been recognized in 2004, IMRF will begin 2005 with no unrecognized gains or losses for actuarial rate setting purposes.

Impact on Employer Reserves

By statute, IMRF must credit approximately $725 million to member and retiree reserves. After applying these credits and covering administrative and direct investment expenses, IMRF will credit approximately $1.3 billion to employer reserve balances:

- Approximately $486 million will be credited at 7.5% on beginning of the year positive employer reserve balances.

- The remaining amount—approximately $814 million—will be credited to all employers as residual investment income.

On average, employers will receive a credit of approximately 19% based on their 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. As they did in 2003, IMRF employers will receive a significant financial benefit in 2004.

Employer Funding Status

IMRF's 2004 overall funded status on an actuarial basis is expected to decline from 97.6% as of year-end 2003 to 95.1% at year-end 2004.

This decrease is due to the fact that on an *actuarial* basis IMRF earned less 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 91.0% to 95.1%; this increase reflects IMRF's 12.1% market return in 2004.

Since there are no unrecognized investment gains or losses as of year-end 2004, the actuarial funded status is equal to the market value funded status.

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 underfunding, 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 8.61% of payroll in 2005. Put another way, for each dollar of service an employee renders, the employer also incurs a liability of 8.61 cents. To the extent that an employer was overfunded, the 8.61 cents was reduced to amortize its surplus.

The **average employer rate** for the regular plan **for 2005 is 9.25%** and reflects that the regular plan is less than 100% funded. This is the first time since 1999 that the average rate for the regular plan has been higher than 8.61%.

The impact of 2004 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 2004 with $1.2 billion of unrecognized investment losses. These losses were a result of the difficult financial markets in 2000, 2001 and 2002. However, due to the significant returns of 2004 and 2003, IMRF will have no unrecognized investment losses at the end of 2004.

Since IMRF's actuarial return was 4.6% in 2004, less that the 7.5% assumed return, the **average employer rate for the regular plan** is expected to increase to **9.73% in 2006.** If IMRF is able to earn a market return of 7.5% in 2005, the average rate for the regular plan will begin decreasing in 2007.

The average employer rate for the regular plan was 7.82% for 2004 and will be 9.25% for 2005, an increase of 143 basis points or 18%. We estimate the average employer contribution for the regular plan for 2006 will be 9.73%, an increase of 48 basis points or 5%.

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 2006.

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IMRF Meetings

IMRF will schedule a series of meetings throughout the state to discuss the potential impact of 2004 investment returns on individual employers in 2006 and beyond as well as the underlying concepts driving reserve balances, funding levels, and contribution rates and to answer any specific questions you or any other representatives of your organization might have. These meeting will also provide us the opportunity to discuss certain initiatives we are undertaking to improve your retirement system.

The dates and locations will be provided in a subsequent General Memorandum. The meetings will be held after you receive your 2006 Advance Rate Notice in early April 2005.

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