Illinois Municipal Retirement Fund
2211 York Road Suite 500 Oak Brook IL 60523-2337
Service Representatives 1-800-ASK-IMRF
www.imrf.org

GENERAL MEMORANDUM

Number: 551

Date: February 16, 2007

To: All Authorized Agents

Subject: Impact of 2006 Investment Return on Employer Funding Status, Employer Reserves, 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 body members.

Executive Summary

The estimated 2006 investment return for IMRF is 13.9%. This return translates into investment income of approximately $2.67 billion and, on an estimated basis, has pushed IMRF's funded status to over 100% on a market value basis.

IMRF's returns for the 2006-2002 period were 13.9%, 8.7%, 12.4%, 22.6%, and -8.7%. While IMRF earned 13.9% on a *market* basis in 2006, its *actuarial* return, which is the return that impacts employer contribution rates, was 8.8%. This is higher than the actuarial investment return assumption of 7.5%.

Background

As a defined benefit plan, investment return fluctuations have no impact on the benefits payable to 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 a member 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.

- over-

While investment return fluctuations do not impact member benefits, they do impact funding status, individual employer reserve balances, and employer contribution rates.

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 2006 investment return on a market basis is 13.9%. However, for actuarial purposes, IMRF uses a common pension industry practice of five-year averaging of actual market returns to arrive at the *actuarial* return of 8.8%.

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 2006, IMRF will be adjusting its *assumed* investment income of $1,476 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 $1,722 million. IMRF will begin 2007 with $960 million of unrecognized gains for actuarial rate-setting purposes, which will be recognized over the next four years. This provides a cushion against future employer contribution rate increases should investment returns drop below 7.5%.

Employer Funding Status

IMRF's 2006 overall funded status on an actuarial basis is expected to increase from 94.6% as of year-end 2005 to 96.2% at year-end 2006. 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 95.5% to 100.5%, which reflects the 13.9% market return in 2006.

On a preliminary basis, it appears IMRF will have reached its goal of 100% funding on a market basis. If IMRF earns its actuarial assumed investment return of 7.5% over the next four years, it will also reach its 100% funding goal on an actuarial basis by 2010. If actual returns exceed 7.5% over the next four years, IMRF will reach 100% funding on an actuarial basis sooner.

Most individual employers can expect that their Regular plan funded status will improve modestly on an actuarial basis but will improve more significantly on a 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.

Impact on Employer Reserves

By statute, IMRF must credit member and retiree reserves with 7.5% interest (approximately $859 million for 2006). After providing for these credits and covering administrative and direct investment expenses, approximately $1,879 million will be credited to employer reserve balances.

IMRF will also credit beginning of the year positive employer reserve balances with 7.5% interest (approximately $610 million for 2006). The remaining amount of investment income (approximately $1,269 million) will be distributed to all employers as residual investment income.

On average, employers will receive a credit of approximately 22% 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.

IMRF employers have received significant financial benefits over the last four years from the distribution of residual investment income—$1,269 million in 2006, $188 million in 2005, $814 million in 2004, and $2,060 million in 2003.

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 8.49% of payroll in 2007. Put another way, for each dollar of service an employee renders, the employer also incurs a pension cost of 8.49 cents. To the extent an employer is overfunded, the 8.49 cents is reduced to amortize its surplus. To the extent an employer is underfunded, the 8.49 cents is increased to amortize the shortfall.

The average employer rate for the Regular plan for 2007 is 9.72% and reflects the fact that the Regular plan is currently less than 100% funded on an actuarial basis.

The impact of 2006 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 8.8% in 2006, more than the 7.5% assumed return, the average employer rate for the Regular plan is expected to decrease to 9.33% in 2008. If IMRF is able to earn a market return of 7.5% or more in 2007, the average rate for the Regular plan will continue to decrease for 2009.

The average employer rate for the Regular plan was 10.04% for 2006 and will be 9.72% for 2007, a decrease of 32 basis points or 3%. A rough estimate of the average employer contribution rate for the Regular plan for 2008 is 9.33%, a decrease of 39 basis points, or 4%.

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 2008.

IMRF Meetings

In order to discuss the potential impact on individual employers in 2008 and beyond, as well as the underlying concepts driving funding levels, reserve balances, 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 2008 Advance Rate Notice. IMRF will mail the Advance Rate Notices in early April 2007.

Questions

If you have any questions regarding the information presented in this memorandum, please call or e-mail Chief Financial Officer Richard DeCleene at (630) 368-5345 or rdecleene@imrf.org.

Sincerely,

Louis W. Kosiba
Executive Director