Illinois Municipal Retirement Fund

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GENERAL MEMORANDUM

Number: 622

Date: January 31, 2012

To: All Authorized Agents

Subject: Impact of 2011 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

This preliminary information is based on unaudited investment return data and projected actuarial information. Finalized information will be available in early May 2012.

The financial markets in 2011 were very volatile with significant swings on a monthly basis; much of the volatility was driven by the European debt crisis.

The estimated 2011 investment return for IMRF is a negative .5%. This return translates into an investment loss of approximately $57 million. From an actuarial basis, IMRF assumed it would earn $1.979 billion. The fact that IMRF fell approximately $2 billion short of its anticipated actuarial return will put upward pressure on future employer contribution rates.

Member and annuitant reserves will be credited approximately $1.26 billion as required by the Illinois Pension Code. Therefore, employer reserve balances will be charged approximately $1.44 billion to cover these credits, administrative and direct investment expenses and the investment loss.

On average, employer accounts will be charged approximately 18% on their beginning of the year employer reserve balance. These charges reflect the fact that, as a member of a defined benefit plan, IMRF employers share all the risks and rewards of investment returns.

The phase-in plan adopted by the IMRF Board of Trustees in 2009 (and modified in July 2011) will remain in effect for 2013 rate purposes.

Beginning on April 23, 2012, IMRF will present a series of Employer Rate meetings throughout the state. We will discuss the impact of year-end financial and actuarial data on IMRF as a whole and its estimated impact on individual employers. We will also discuss other current topics impacting IMRF and pension plans in general. IMRF will present the same information at a webinar in early May.

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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.

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 fully funded. The Illinois Pension Code [40 ILCS-7-172(b)(2)] requires the amortization of any unfunded liabilities over the period allowable under generally accepted accounting principles.

Investment Returns

Financial markets in 2011 were very volatile. After positive returns in the first four months that totaled over $1.7 billion, IMRF suffered losses in May through September resulting in year-to-date investment losses of approximately $1.5 billion as of September 30, 2011. However, in October alone, IMRF earned more than $1.6 billion. Market volatility continued in November when IMRF lost more than $300 million. As noted earlier, for the full year IMRF lost approximately $57 million.

IMRF's estimated 2011 investment return on a market basis is a negative .5%. 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 6.8%.

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 market returns that either exceed or fall short of the assumed actuarial return of 7.5% subject to a 20% corridor. (A 20% corridor means that the actuarial value of plan assets have to be within plus or minus 20% of the market value of assets. For example, if the market value of plan assets is $25 billion, the actuarial value of plan assets must be between $20 billion and $30 billion.)

For 2011, IMRF will be reducing its assumed investment income of $1,814 million (a 7.5% return on the beginning of the year actuarial value of IMRF investments) by $173 million. Thus, for actuarial purposes, IMRF's investment return will be an approximate return of $1,641 million. IMRF will begin 2012 with $912 million of unrecognized losses for actuarial rate-setting purposes, which will be recognized over the next four years. (IMRF began 2011 with $881 million of unrecognized gains.)

As these unrecognized losses are flowed into actuarial calculations, they will put downward pressure on the actuarial funded status and upward pressure on future employer contribution rates.

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Employer Funding Status

IMRF's 2011 aggregate funded status on an *actuarial* basis is expected to increase from 83.3% as of year-end 2010 to 83.4% at year-end 2011.

However, on a *market* value basis (which does not reflect the five-year averaging technique or the 20% corridor), IMRF's funded status is projected to decrease from 86.3% to 80.4%, which reflects the negative .5% market return in 2011.

Absent any significant changes in actuarial experience, most individual employers can expect the funded status of their plan to remain basically unchanged on an actuarial basis but to decrease on a market value basis.

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

Impact on Employer Reserves

By statute, IMRF must credit member and retiree reserves with 7.5% interest (approximately $1,258 million for 2011). After providing these credits and covering administrative and direct investment expenses of approximately $96 million and the investment loss of approximately $57 million, approximately $1,436 million will be charged to employer reserve balances. The $1,436 million charge is the amount by which 2011 investment income fell short of the interest credited to member and retiree reserves and the administrative and direct investment expenses of the plan.

On average, employers will be charged approximately 18% based on their beginning of the year employer reserve balance. This credit reflects the fact that, as a member of a defined benefit plan, IMRF employers share all the risks and rewards of investment returns. The actual amount credited to individual employers will vary from the average due to differences in annuitant reserve amounts.

Over the last nine years, IMRF employers have been credited or (charged) the following amounts—($1,436) million in 2011, $1,713 million in 2010, $3,461 million in 2009, ($7,100) million in 2008, $871 million in 2007, $1,879 million in 2006, $753 million in 2005, $1,300 million in 2004, and $2,393 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 payment)
- Amortization of over or under funding
- Early retirement incentives (employer option)

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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 8.52% of payroll in 2012. Put another way, for each dollar of service an employee renders, the employer also incurs a pension cost of 8.52 cents. To the extent an employer is overfunded, the 8.52 cents is reduced to amortize its surplus. To the extent an employer is underfunded, the 8.52 cents is increased to collect the shortfall.

The average employer rate for the Regular plan was 11.47% for 2011 and is 12.09% for 2012, an increase in the rate of .62%. On a percentage basis, the average rate increased 5.4%. The average rates for 2011 and 2012 reflect employers who are contributing using the actuarial required contribution (ARC) rate and also employers who are contributing using the lower optional phase-in rate. (The percentage increase for employers who chose the phase-in rate in 2012 is 9.8%.) The 12.09% rate reflects the fact that the Regular plan was less than 100% funded on an actuarial basis as of December 31, 2010.

The impact of 2011 investment returns on individual employer 2013 contribution rates is difficult to forecast, since each employer has a unique rate affected by its own demographics and funded status as well as its mix of Tier 1 and Tier 2 members.

Phase-in plan remains in effect, modified in 2011

The phase-in plan adopted by the IMRF Board of Trustees in 2009 remains in effect for 2013 employer contribution rates with one modification. At its July 2011 Board meeting, the IMRF Trustees adopted the following modification to the phase-in plan adopted in 2009:

- For 2013
  Employers who were on the phase-in plan in 2012 will see their 2013 rate increase by 10% from their 2012 rate or by one-third of the difference between their 2012 rate and their actuarial required contribution for 2013 whichever is greater. In all cases, the total increase will not exceed the actuarial required contribution for 2013. Approximately 2% of wages reported for the Regular plan in 2011 were for Tier 2 members.

- For 2014
  Employers who were on the phase-in plan in 2013 will see their 2014 rate increase by 10% from their 2013 rate or by one-half of the difference between their 2013 rate and their actuarial required contribution for 2014 whichever is greater. In all cases, the total increase will not exceed the actuarial required contribution for 2014.

- For 2015
  All employers will pay the actuarial required contribution.

With regard to the Regular plan, there are three employer groups to consider when discussing the impact of 2011 investment returns on 2013 employer contribution rates:

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- *Employers who are contributing using the ARC in 2012*
  For employers who are contributing using the ARC in 2012, the average ARC rate is estimated to decrease from 2012 to 2013 by approximately .24%. However, this projection is based on IMRF-wide averages; individual employers could vary widely. Secondly, the ARC does not reflect the impact of Tier 2 on 2013 rates. The Tier 2 impact is expected to lower (but not dramatically) the current estimate of the average 2013 ARC for the Regular plan.

- *Employers who are contributing based upon optional phase-in rates in 2012*
  For employers who are contributing using an optional phase-in rate in 2012, the phase-in plan will remain in effect. Any increase will be limited to 10%, except for those employers impacted by the modification noted above. For some of the employers in this group, their 2013 ARC rate may be less than a 10% increase from their 2012 rate. In these cases, their 2013 rate will be the ARC rate.

- *Employers who were overfunded at the end of 2010 and were contributing at less than the full cost of the IMRF program (approximately 8.52% of payroll) but who will be underfunded at the end of 2011*
  A small group of employers were overfunded at the end of 2010 but will be underfunded at the end of 2011. Their 2013 rate increase will not be subject to a cap. Similar to prior years, these employers will have to contribute the full cost of the program, which is approximately 8.52% of payroll. While this group's percentage increase will exceed 10%, their absolute rate will be lower than most employers in the first two groups.

IMRF Meetings
To discuss the potential impact on individual employers in 2013 and beyond, IMRF will conduct a series of Employer Rate meetings throughout the state beginning April 23, 2012. We will also discuss other current topics impacting IMRF and pension plans in general.

In early May, IMRF will present a webinar in which this information will also be discussed. Details concerning these meetings and the webinar will be furnished in a subsequent General Memorandum.

IMRF will publish the time, date and locations of the Employer Rate meetings and the time and date of the related webinar in early to mid-March.

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