State Auditor's Office
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State Auditor

A Legislative Summary Document Regarding

Teacher Retirement System

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Teacher Retirement System (TRS) investment program and practices are well structured and managed in an effective and professional manner. However, developments in the securities markets and accepted pension industry best practices are becoming increasingly out of sync with current Texas statutory and constitutional provisions. Consequently, legal constraints exist that may inhibit TRS's efforts to maximize investment returns, minimize risk, and operate efficiently.

On August 31, 2002, TRS had an unfunded actuarial accrued liability of $3.3 billion. Even if pension plan benefits remain the same, additional funding (above the current contribution rates) of more than $260 million per year would be needed to amortize the unfunded liability over a 30-year period.

Unless the pension plan's contribution rate increases or investment returns are significantly greater than expected, it might not be possible to provide pension benefit increases during the 78th Legislative Session and possibly within most of the current decade. According to the System's actuary, if there is no significant market recovery over the near term, an increase in the contribution rate will be necessary to maintain the actuarial soundness of the System.

The pension plan's actuarial valuation does not include net investment losses of $16.2 billion. These losses will be recognized during the next four years in accordance with TRS's actuary's use of a smoothing process to translate annual market returns to actuarial returns. To offset these losses, TRS's actuary estimates that the pension plan would need to average a 12.4 percent return on investments during the next four years (or a 21.2 percent return on investments during the next three years) to achieve its 8 percent actuarial expected investment rate.

The retiree health insurance plan's net assets grew during fiscal year 2002, but only because of $285.5 million in supplemental state appropriations. Excluding the supplemental state appropriations, the plan's expenditures exceeded the plan's contributions by $177.6 million in fiscal year 2002. Significant changes will have to be made to keep the plan solvent.

Under the current funding arrangement and benefit structure, the retiree health insurance plan is projected to need an additional $720 million above amounts appropriated for the 2002–2003 biennium to pay claims incurred through August 31, 2005. TRS's management has been closely monitoring the funding status of the retiree health insurance plan and reporting information regarding the plan's funding status to state leaders on a monthly basis for the last three years.

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SAO No. 03-333

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Key Findings from Previous Audits and Reviews

January 1, 2001–December 31, 2002

Ongoing Comparative Investment Performance Report for Major Investing Entities

The State Auditor's Office will release a report in early 2003 on the investment performance of the Teacher Retirement System.

Ongoing Audit of the Financial Statements of the Teacher Retirement System for the Fiscal Year Ended August 31, 2002

The State Auditor's Office will release a report in early 2003 on the audit of the Teacher Retirement System's Financial Statements for the fiscal year ended August 31, 2002.

An Independent Review of the Teacher Retirement System Investment Program Conducted by Independent Fiduciary Services, Inc., Under Contract to the State Auditor's Office

(Report No. 02-021, February 2002)

The State Auditor's Office contracted with Independent Fiduciary Services, Inc. (IFS), to perform an independent evaluation of the Teacher Retirement System's (TRS) investment program and practices on behalf of the Legislative Audit Committee. IFS found that, based on current requirements of state law, TRS investment program and practices were:

> . . . well structured and managed in an effective and professional manner. TRS is a leader in the pension fund industry, and in many respects its investment program and processes are emblematic of "best practices" used by other large public pension funds. Compared to [IFS's previous 1996 report], the increased professionalism and preparedness of both the members of the Board of Trustees and the investment staff are impressive.

Status of Audit Recommendations as of November 30, 2002 (unaudited)

TRS has reported the following:

Implemented	25
Partially implemented	23
Factors delay implementation	2
Does not plan to take corrective action	7
Has other explanatory information	5
Total recommendations	**62**

However, IFS reported that developments in the securities markets and accepted pension industry best practices are becoming increasingly out of sync with current Texas statutory and constitutional provisions. IFS did not identify any legal constraints that are harmful to TRS's investment program, but it did identify legal constraints that inhibit TRS's efforts to maximize investment returns, minimize risk, and operate efficiently. IFS's recommendations were built around the principle that the TRS Board of Trustees (Board), as the fiduciary responsible for the effective management of the TRS Trust Fund, should be given the freedom to manage its responsibility prudently according to its best judgment. This freedom of prudent action should be counterbalanced by a high degree of accountability.

IFS's key legislative recommendations are summarized as follows:

- Make explicit the TRS Board's ability to delegate investment authority to internal staff.
- Allow the Board to delegate investment authority to external managers when warranted, subject to strict fiduciary standards.
- Allow the Board to invest in any asset class, instrument, or strategy it deems prudent.
- Grant the Board budgetary, personnel, and procurement autonomy as it pertains to the investment program, while maintaining strict reporting and accountability to the Legislature.

- Offset increased Board autonomy by imposing the modern, prudent person standard of care.

- Use the principles imbedded in the Uniform Prudent Investor Act and the Uniform Management of Public Employees Retirement Systems Act.

Specifically, IFS states:

> . . . TRS could further optimize its management effectiveness if legal constraints on Board authority regarding the investment program, budgetary process, procurement, and personnel matters were significantly eased or removed. . . . Reducing these constraints—while still retaining essential safeguards—could make an already well run and well organized pension fund even stronger, thus facilitating TRS's ability to meet the retirement needs of its beneficiaries while minimizing TRS's reliance on general revenue appropriations.

An Audit of the Financial Statements of the Teacher Retirement System for the Fiscal Year Ended August 31, 2001

(Report No. 02-015, December 2001)

The State Auditor's Office concluded that the financial statements of the Teacher Retirement System (TRS) for fiscal year 2001 were materially correct in accordance with accounting principles generally accepted in the United States. In addition, we noted no problems with TRS's financial statements, compliance, or internal control. This is the fourth consecutive year in which we found no instances of significant noncompliance or material weaknesses in internal control.

TRS's actuary reported that TRS's pension plan remains actuarially fully funded as of August 31, 2001. However, because the plan's normal cost rate now exceeds the contribution rate and there is a large amount of deferred investment losses, future pension plan benefit increases might not be statutorily permitted without an increase in contribution rates and/or improvements in investment returns.

Other key facts and findings are as follows:

- The net assets of the pension trust fund decreased by $10.6 billion to $79.4 billion during fiscal year 2001, largely because of adverse market conditions.

- The pension plan membership surpassed one million members for the first time as of August 31, 2001.

- Retiree insurance plan expenses exceeded revenues by $60 million during the fiscal year.

A Follow-up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities

(Report No. 01-017, January 2001)

The Teacher Retirement System and the Employees Retirement System, with combined portfolios of approximately $110 billion as of August 31, 2000, are the only major investing entities that lack authority to delegate investment decisions to external money managers. Both agencies might be able to better diversify their investment portfolios if permitted to delegate some investment decisions to outside investment professionals. This authority could permit access to additional asset classes that might be highly profitable or that could help control overall portfolio risk but that would be difficult or impossible for internal staff to manage alone.

Teacher Retirement System

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Quality Assurance Team Reviews Conducted by the Legislative Budget Board and State Auditor's Office

Completed Projects ***Quality Assurance Team Annual Report – January 2002***

Teacher Retirement System (TRS) completed the Microfiche Backfile Conversion project at a total cost of $4,498,749.

Canceled Projects ***Quality Assurance Team Annual Report – January 2002***

TRS canceled the BeST – Benefit Services Transformation Project at a total cost of $14,528,735.

Information System Vulnerability Assessments

The State Auditor's Office (SAO) and/or the Department of Information Resources performed one or more information system vulnerability assessments at the Teacher Retirement System between January 2000 and November 2002. Detailed results of this work are confidential under Texas Government Code, Section 2054.077(c). The SAO's Legislative Summary Document titled "Information System Vulnerability Assessments" provides general information about the results of information system vulnerability assessments.

Travel Expenditures

Travel Expenditures by Appropriation Year (unaudited)

	2000	2001	2002
In-State Travel	$ 98,718	$ 85,381	$ 109,244
Out-of-State Travel	151,612	170,439	191,020
Foreign Travel	30,526	36,157	45,809
Other Travel Costs	4,654	4,300	4,917
Total Travel Expenditures	**$ 285,510**	**$ 296,277**	**$ 350,991**
Limit on Travel Expenditures (Cap)	337,472	337,472	425,000 [a]
Expenditures in Excess of Cap	**$ 0**	**$ 0**	**$ 0**

[a] Caps apply to total travel in appropriation years 2000 and 2001, but caps apply only to out-of-state travel and foreign travel in appropriation year 2002. Caps, calculated by the Comptroller of Public Accounts, have been adjusted for any increases requested by TRS and approved by the Legislative Budget Board in accordance with the General Appropriations Act. The cap for appropriation year 2002 was established by General Appropriations Act, 77th Legislature, III-42, Rider 8.

Source: Uniform Statewide Accounting System (USAS) as of November 30, 2002. Amounts are subject to change as agencies continue to record additional expenditures or adjustments.