Staff Report

to the

Sunset Advisory Commission

on the

Teacher Retirement System of Texas

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EXECUTIVE SUMMARY

APPROACH

To adequately address concerns raised by legislators, the Attorney General, the Travis County District Attorney, teachers and retirees, in reviewing the Texas Teacher Retirement System, Sunset staff approached this review jointly with the Legislative Budget Board staff. The contributions of LBB staff and actuary were crucial to this effort and are reflected throughout this report. Without this interagency cooperation, many of the findings and recommendations contained here would not have been possible.

The review focused on the three components of the System—the Teacher Retirement Fund (Fund), the Board of Trustees and the administrative staff hired by the Trustees.

Foremost in our efforts was the protection of the financial health of the Retirement Fund and its continuing ability to pay retirement benefits in the future.

The review examined operations of the Board of Trustees and looked for ways to strengthen the Board's ability to deal with its investment and administrative duties.

Finally, the Sunset staff examined the accountability and efficiency of the hired administrative staff.

In conducting the review of the Teacher Retirement System, Sunset staff:

- Surveyed relevant provisions of the Constitution and state law regarding retirement systems;
- Attended TRS Trustee meetings, consulted with Trustees, and reviewed minutes, publications and internal policies of the agency;
- Reviewed past reports prepared on TRS by the Texas Education Agency, State Comptroller, State Auditor, Legislative Budget Board, Attorney General and the Pension Review Board;
- Attended a briefing on legislative oversight of pension systems sponsored by the National Conference of State Legislators and presented by the National Conference on Teacher Retirement;
- Worked with other state agencies including the Legislative Budget Board, Legislative Council, State Auditor, Texas Performance Review, Texas Employees Retirement System,

Foremost in the Sunset review is the protection of the financial health of the Retirement Fund.

General Services Commission and Pension Review Board to gain an understanding of the factors relevant to TRS administration;

- Surveyed interested educator groups, seeking their suggestions and impressions of operations of the System;
- Worked with the TRS actuary, Legislative Budget Board and its independent actuary to gain an understanding of actuarial assumptions used by TRS;
- Attended a counseling session presented by TRS staff;
- Surveyed other large public pension funds in the United States;
- Consulted with investment experts and staff of other major pension funds; and
- Studied TRS' Austin headquarters operations and facilities.

THE TEACHER RETIREMENT FUND

The Texas Teacher Retirement Fund is a $38 billion trust composed of membership and legislative contributions and the investment earnings on these accumulated contributions.

The Fund is a literal matter of life or death for many retired Texas teachers and education workers. Since most do not receive Social Security, it represents their only retirement income—or hope of retirement income.

Without Social Security, few retired teachers qualify for Medicare benefits. The separate Retired School Employees Group Insurance Fund provides the only help with medical expenses.

In a profession historically marked by low pay, the Teacher Retirement Fund is a beacon of hope for hundreds of thousands of public school workers, the hope of a dignified retirement at the end of a career serving Texas schoolchildren.

Unfortunately, the level of retirement income provided by the Fund for many retirees, especially those whose careers were in the period when annual pay scarcely exceeded four digits, is too low. Sunset staff saw annuity checks of as little as one dollar per month. More than 22,000 retired Texas educators receive $200 a month, or less.

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The Sunset review found the Retirement Fund to be sound. In fact, its present condition is better than sound—it is robust. It carries the accumulated wealth of the booming 1970s and 1980s, minus losses of around a half billion dollars from an ill-fated venture into a crashing real estate market in the 1980s. These losses may or may not ever be fully recovered.

But while the Fund is sound today, the outlook for the future merits watchful concern.

- Investment earning rates, which affect the growth of the Fund, have dropped markedly and most investors do not expect to see the high investment returns of previous decades.
- The Retirement Fund's investment performance fell well short of its expected 8 percent rate of return last year, earning 2 percent. Continued weak performance is expected for TRS investments in the coming year as well.
- Trustees have abolished an investment advisory committee composed of financial management professionals to provide outside advice on investments.
- For the first time in the Fund's history, next year the Texas Teacher Retirement Fund is projected to pay out more money than state and member contributions bring in. While this is common for maturing pension funds, it imposes new pressures on investment earnings.
- The coming retirement of the baby boomer generation will place added pressures on the Fund's performance. According to Cynthia Moore, Washington counsel to the National Council on Teacher Retirement,

"The administration of state and local pension plans is going to get more challenging. Population trends in the U.S. are not encouraging. Right now we have enough people to support our retirees. But when baby boomers retire, there will be far fewer taxpayers to pay for retirement programs."

The Board of Trustees

The Texas Constitution places responsibility for investing the accumulated contributions and for administration—making payments to retirees—with the nine-member Board of Trustees. Setting benefits and maintaining the financial health of the Fund are responsibilities of Texas Legislators.

The present structure of the Board requires only two of its nine members to have financial or business expertise. The remainder are either selected by the Governor from among nominees voted upon by various segments of the education community or appointed by the State Board of Education.

Since the employees of the Texas Education Agency, who work for the State Board of Education and its Commissioner of Education, have transferred their membership to the Employees Retirement System, there is an opportunity to realign Board membership to provide the crucial business and financial expertise needed to guide

Administration of public pension funds will get more challenging as the baby boom generation retires.

investment of one of the nation's largest retirement funds in the years ahead.

Ultimately, the responsibility for maintaining the financial health of the Fund rests with the Legislature's ability to control payments (benefits) and provide new revenue (contributions).

While the Legislature is constitutionally bound to ensure the financial health of the Fund, Trustees are required by the Constitution to invest those funds. However, since the Trustees are predominately educators, it should be recognized that they also have a vested interest in increasing benefits.

The TRS administration seems to have lost its sense of constitutional direction.

In recent years, zealous advocacy of benefit increases by the Trustees has colored their pronouncements and undermined the credibility of such pronouncements with the Legislature.

TRS Administration

As provided by state law, the Trustees select an executive director who in turn oversees a staff of more than 400 employees to administer the Retirement System—pay retirement benefits.

Funding for operations of this hired administrative staff is provided by the Trustees reaching directly into the Teacher Retirement Fund for whatever sums are necessary to pay for its overhead. In 1994, these expenditures included budgeted expenses of $27.2 million; brokerage commissions of $23 million and real estate management and advisor expenses of $59.5 million.

While state government as a whole has reformed budget procedures and mandated efficiency measures to control the growth of administrative costs for state government generally, these reforms and efficiency measures have not been applied to TRS hired staff.

While legislative reforms have limited the growth of state administrative expenses in the past 5 years, TRS operating expenses have risen 66 percent faster than the state as a whole; and significantly faster than pension funds in other states subject to oversight beyond their own trustees.

Bureaucratic extravagance at TRS has previously drawn the attention of other reviews. The State Comptroller awarded his first "Silver Snout" award for lavish spending to the TRS for its headquarters building and furnishings. The State Auditor reported unexplained growth in administrative expenses in a 1992 review.

Sunset staff also examined the role of TRS administration in relation to the positions taken by their bosses, the Fund Trustees, and found problems of staff actions reflecting the vested interest rather than the constitutional responsibilities of Trustees.

While the review revealed solid economic underpinnings for the Teacher Retirement System, it also revealed an agency which seems to have lost its sense of its constitutional direction. Correspondence from both retirees and active teachers reflected concerns about a perceived threat to their retirement benefits. These benefits are safe beyond the shadow of a doubt, yet the misinformation encountered by Sunset staff was, at worst, spread by TRS administration for cynical bureaucratic advantage or, at best, not dealt with in a factual manner.

RECOMMENDATIONS

1. Use available pension funds to raise retirement benefits for the oldest career educators and provide cost of living increases for all retirees.

Sunset staff examined the assets of the Fund and, with crucial assistance from staff and actuary of the Legislative Budget Board, confirmed that the Fund has sufficient capital and income to offer current retirees the largest benefit increase in the System's history, even at or near constitutional minimum contribution rates. The benefit increase proposal in Issue One of this report would raise the service minimum for the first time in 24 years, pulling more than 6,000 retired career educators out of poverty and providing increases against the effects of inflation for every single current retiree.

2. Expand the TRS health insurance program to cover the entire public education community.

Sunset staff recommends an affordable option to provide health insurance for Texas educators by expanding the optional TRS Care 3 group insurance plan operated by TRS to all Texas school districts who choose to participate. Over time, this recommendation could provide needed health insurance to active Texas educators, as well as reduce costs for participating retirees.

3. Improve monitoring of investment performance for Trustees and the Legislature.

Responding to problems encountered in evaluating present Fund investment performance, in addition to concerns raised by Legislative leaders, the Attorney General and the Travis County District Attorney, Sunset staff recommends the Legislative Audit Committee hire necessary professionals to evaluate the investment performance of the Teacher Retirement Fund and help formulate uniform reporting requirements for all state pension funds.

Fund performance should be more closely evaluated and monitored to address concerns raised by legislative leaders, the Attorney General and District Attorney.

Applying standard state efficiency measures to TRS administration will preserve members' funds.

4. Bring more business expertise to the Board of Trustees.

In response to recent problems with below-expected investment performance, the increased importance of investment earnings in maintaining cash flow, and the abolition of a committee of outside experts to advise Trustees, as well as shifts in TRS membership, Sunset staff recommends changes in governance to ensure future Fund performance.

5. Increase legislative oversight of operating expenses, allowing member funds to be used solely for benefits.

Including TRS administration in the state's reformed performance budgeting system can save member funds by applying standard state efficiency measures to TRS operations. Sunset staff recommends legislative appropriation of operating expenses together with a mechanism to channel additional savings due to operational efficiency into the Retirement Fund as well.

6. Prohibit TRS from lobbying.

Although the Legislature has attempted to control advocacy by TRS Trustees and staff with riders to the appropriations bill, enforcement of these provisions would only penalize TRS members, rather than the individuals responsible for committing prohibited acts. Sunset staff recommends such prohibitions be made enforceable and that information be provided by the more objective Pension Review Board.

7. Increase funds for retiree benefits by making economical use of TRS headquarters facilities.

Applying just one of several new standards adopted in recent years to control administrative spending in other state agencies, the Sunset staff identified $1.72 million in savings each budget period that could go to the Retirement Fund if TRS followed state standards on office space utilization and leased out excess headquarters space.

8. Require TRS to increase the use of businesses owned by women and minorities.

Although other state agencies have made dramatic progress toward increasing purchases and contracts with Historically Underutilized Businesses (HUBs) owned by minorities and women, TRS has not matched these increases. It should.

9. Require TRS administration to be subject to the appropriations process; schedule a Sunset review in 2007.

Currently, TRS administration is not subject to the oversight of the appropriation process and is scheduled to be permanently removed from under the Sunset process in 1995. Sunset staff recommends that TRS should continue to be subject to the Sunset Act and that if TRS administration is not placed in the appropriations process, it should undergo a Sunset review in 1997. If TRS administration is subject to the appropriations process, it should undergo review in 2007, the standard 12-year cycle.

ISSUE 1

USE AVAILABLE PENSION FUNDS TO RAISE RETIREMENT BENEFITS FOR THE OLDEST CAREER EDUCATORS AND PROVIDE COST OF LIVING INCREASES FOR ALL RETIREES.

BACKGROUND

The Teacher Retirement System annually provides more than $1.5 billion in retirement, disability retirement, and survivor benefits to 138,000 educators. While the largest number retired in the last decade, many have been retired for 20 years or more. The chart, *Retirees by Year of Retirement,* shows the number by year.

The Teacher Retirement System is a defined benefit plan. Teachers and other members receive fixed monthly benefits based on their age at retirement, years of service, and highest three years of salary. Standard retirement with full benefits is at age 55 with 30 years of service while early retirement is available with reduced benefits.

Standard retirement payments are calculated by multiplying the member's years of service by 2 percent and then multiplying the result against the member's average three highest annual salaries. For example, a 55-year-old teacher with 30 years of service and an average highest salary of $30,000 would receive 60 percent (2 percent times 30 years) of $30,000, or $18,000 per year.

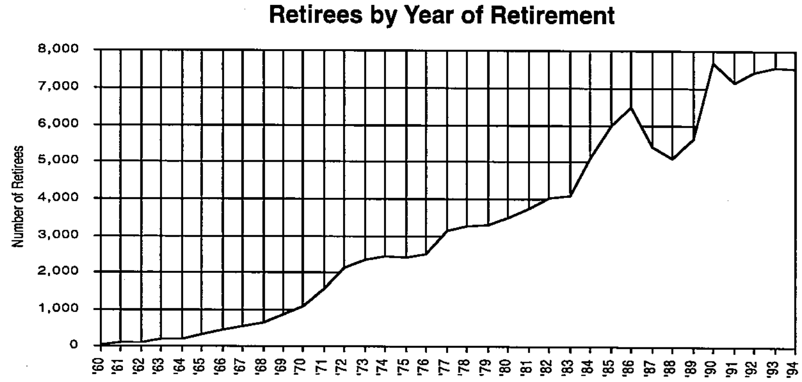
Minimum retirement payments are the higher of $150 per month for members age 65 or older at time of retirement, or $6.50 per month for each year of service regardless of age. For example, the minimum benefit for a 30-year teacher would be $195 per month ($6.50 times 30 years).

Over time, inflation has eroded the monthly benefits of some long-time retirees. Also, many of the oldest educators retired before dramatic increases in pay and the cost of living in the 1970s and 1980s. Their benefits today are still based upon historically low salaries.

To help address these low pensions and to counter the effects

Minimum teacher pay has risen 430 percent since 1960. The base pay of most older career educators did not reflect this increase.

Retirees by Year of Retirement



35,000 TRS retirees receive monthly benefits of $1,000 or less.

of inflation, every Texas Legislature since 1975 has approved benefit increases for retirees. Although the Legislature did not fund an annuity increase in 1985, it established and funded the TRS-Care program to provide health insurance to retirees.

Benefit increases have been targeted to attempt to provide larger percentage increases to members who have been retired the longest. The history of these increases is shown in the chart, *Legislative Increases for Teacher Retirement, 1967 - 1993.*

In the past decade, benefit increases have totaled $2.2 billion. The Legislature's strategy in providing increases has been to improve benefits as inflation increases. In determining funds available for benefit increases, the Legislature depends on actuarial estimates of the Fund's financial status. The following two pages discuss the recent unprecedented revisions in these estimates and subsequent reactions.

Sunset staff explored the potential of raising the minimum pension as a way of addressing the low benefit levels of long-term retirees. With the help of an independent actuary, staff concluded that it is within the financial means of the Retirement Fund to increase the minimum pension and also provide a 25 percent inflationary ad hoc increase for all retirees even if the state contribution rate was lowered to near the constitutional minimum of 6 percent of each employee's salary.

Legislative Increases for Teacher Retirement 1967 - 1993

1993	5 to 15% based on retirement year before 9/1/91.
1991	1% per year of service before 5/31/89.
1989	4 to 16% based on retirement year - $100 month maximum increase.
1987	5 to 20% based on retirement year.
1984	3 to 9.5% based on retirement year; excluding retirees with compensation more than $25,000.
1981 (B)	2 to 21% based on retirement year.
1981 (A)	5.1% if retired before 5/31/79.
1979	13% for pre-1969 retirees and 6% for post-1969 retirees.
1977	Increased formula for those retired before 5/31/77.
1975	5% - 18% based on retirement year.
1971	10% increase.
1969	10% increase.
1967	Increase of $1.50 per month for each year of retirement.

Source: Pension Review Board and TRS

FINDINGS

▼ **Despite past benefit increases, the pensions of many TRS retirees remain low.**

◗ Of the System's 76,000 retirees who retired at normal retirement age and service, 35,000 receive monthly benefits of $1000 or less. The chart, *Career Retirees by Amount*, shows the distribution of retirees by the amount of their pensions.

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The 1994 Change in Actuarial Assumptions

In June 1994, TRS Trustees adopted the biggest change in the financial outlook of the Teacher Retirement Fund in its 57-year history.

Acting on recommendations of their contracted actuary, Trustees dramatically slashed projections of future pension liabilities from $3.54 billion to $1.75 billion, thus cutting the estimated time to pay off these liabilities from 25.3 years to 5.2 years.

These projections—based upon future earnings on Fund investments, membership growth, inflation, salary increases and mortality rates—reflect the actuary's expectations of future events based on historical trends and patterns and are, in effect, an assessment of the financial status of the Fund, its future income and liabilities. Small changes in the assumptions underlying these projections can have dramatic effects on the Fund's future prospects.

Owing to the unprecedented size of this adjustment, Legislative leaders, Sunset staff and the Legislative Budget Board (LBB) closely examined the Trustees' actions. The LBB contracted with the firm of Coopers & Lybrand to independently assess the economic and actuarial assumptions that composed the new projection.

Coopers & Lybrand confirmed that the new assumptions are reasonable, but said of one factor, membership growth: "relatively little attention was given to it. Since it is a significant assumption, we recommend that thorough consideration be given it."

The revised membership growth factor, which Coopers & Lybrand said warrants more attention, predicts the number of school employees in TRS will grow at a quicker pace than was assumed in previous projections. While this membership growth is a relatively minor factor when the Fund has a short funding period, any increase in benefits extends the funding period and increases the importance of this membership growth assumption. In response to questions from Sunset staff, the independent actuary estimated that a small decline in membership growth could add as much as eight years to the funding period of a system with a funding period of more than 25 years.

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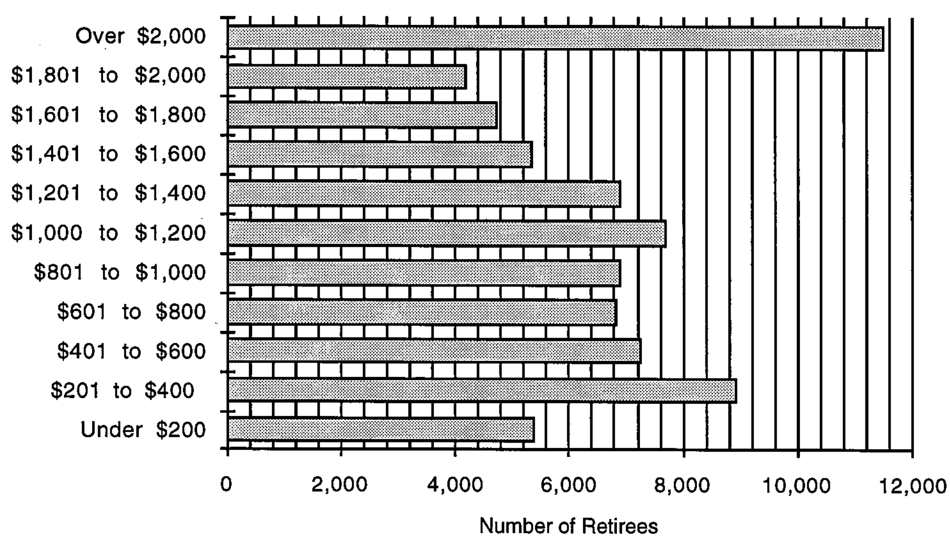
Career Retirees by Amount of Monthly Pension



Actuarial Assumptions *Continued*

Sunset staff questioned the TRS actuary about this assumption and learned that it will be restudied by TRS after the coming legislative session. The actuary also acknowledged that the Governmental Accounting Standards Board (GASB), which oversees U.S. public pension fund accounting, had proposed a new rule providing that growth in pension fund membership can no longer be factored into future actuarial assumptions.

Sunset staff contacted GASB and learned that the rule has been adopted, eliminating membership growth as a factor in future projections of all U.S. public pension funds. This rule change impacts the Fund's liabilities and ability to pay for benefit increases, and means future projections must be made without assuming a growing base of employees contributing to the Fund.

Based on the Trustees' June projections reducing the funding period to 5.2 years, a coalition of education groups proposed increasing the benefit multiplier applied to years of member service from its current 2.0 percent to 2.2 percent and granting a benefit increase for current retirees. This proposal was publicized by TRS in the July 1994 edition of *TRS News*. Based on the June assumptions, an analysis of the proposal by the TRS actuary shows that the proposed multiplier increase would cost $2.3 billion. The proposal also included an increase for TRS members who retired before 1991. This portion of the proposal would cost $900 million, for a total of $3.2 billion in future liabilities. In other words, the proposal publicized by TRS would grant 72 percent of its value to recent and future retirees, and 28 percent to older retirees.

According to TRS, this new proposal would again extend the time necessary to pay off pension liabilities, from 5.2 years back to 29.3 years, or close to the statutory maximum funding period allowed for the retirement fund of 31 years. Based on the membership growth rule change by GASB, Coopers & Lybrand estimated that the proposal would actually extend the funding period to 35.3 years—4.3 years beyond the legal maximum, assuming constant legislative contributions of 7.31 percent of members' salaries.

While the Legislature has historically provided benefit increases and is committed to do so again during the upcoming legislative session, any increases, especially those hinging on the new TRS actuarial assumptions, need to be closely scrutinized. To evidence this, TRS has recently indicated to legislative leaders, LBB and Sunset staff that the proposal reported to members may not be affordable.

TRS advertisement of this benefit increase to active members and retirees through *TRS News* and benefit counseling sessions is not a duty of the agency and may have unrealistically raised the hopes of TRS members. According to a survey prepared by the Wisconsin Retirement Research Committee, out of 81 similar public pension funds surveyed, 67 are at or below a 2.0 multiplier.

The cost of the Sunset staff recommendation, to raise the minimum pension and increase all pensions to recoup 25 percent of the benefit lost to inflation, was calculated by Coopers & Lybrand on assumptions that exclude the growth in membership factor. Even with this conservative approach, the Sunset staff recommendation is affordable at almost any state funding level as described in the fiscal impact on page 15. *See Coopers & Lybrand Report, Appendix 1.*

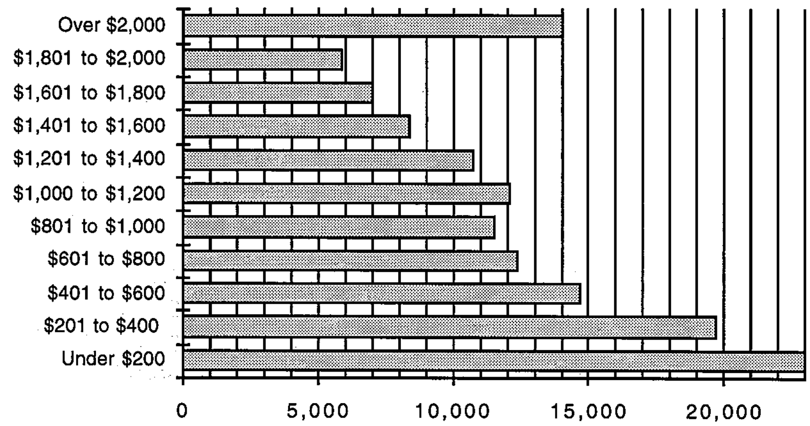
TRS Amoritization Periods
Fiscal Year 1987 - 1994

Year	Funding Period in Years
1987	19.7
1988	17.0
1989	20.9
1990	23.0
1991	28.0
1992	28.8
1993	25.1
1994	5.2

Source: Pension Review Board

◗ In general, the retirees with the lowest average monthly retirement check are those who have been retired longest. For example, the average monthly pension of all TRS members who retired during the decade of the 1960s is $750. This is true despite the fact that these retirees, on average, had the longest careers—25 years—of all TRS members. The chart, *Average Retirement Benefit by Year,* shows the average pension by year of retirement compared to the overall average TRS pension of $1,050.

All Annuitants by Amount of Monthly Pension
(including early, disability and survivors)

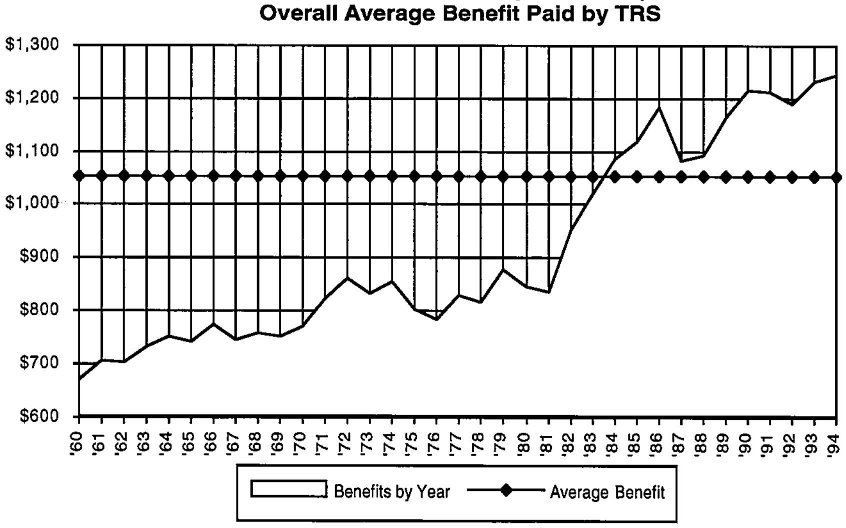


◗ While the average monthly pension of TRS retirees who retired in 1960 with between 26 and 30 years of service is $578, the current poverty line for single persons at 65 and over is $580 —$2 above their pensions.

◗ Further dimming the financial picture of retired educators is the absence of Social Security benefits for most retirees—only 5 percent

The average monthly pension of career teachers who retired in 1960 is $578—slightly below the poverty line.

Average Retirement Benefit by Year Compared to Overall Average Benefit Paid by TRS



A dramatic, but affordable increase in minimum benefits would lift more than 6,000 retirees above poverty.

History of Minimum Annuities

1955	Flat minimum of $100 per month at age 60 with 20 years service or $75 at 65 with 10 years service.
1963	$4.17 per year of service for members with 25 years service.
1971	$6.50 per year of service for "teacher" members. Auxiliary employees—flat minimum of $60 per month at age 65 with 10 years or $95 per month at 60 with 20 years.
1975	Raised auxiliary minimum to $5 per month per year of service.
1977	Established one-class membership bringing minimums for auxiliaries up to teachers.
1991	Flat minimum of $150 per month at age 65.

of Texas' Independent School Districts participate in the Social Security System.

▼ **Giving percentage increases based on inflation does not adequately raise the income of those who need it the most.**

◗ Percentage increases provide progressively smaller amounts for those retirees with small pensions. For example, a 10 percent increase would give members who retired in 1960 with between 26 and 30 years of service with an average pension of $578, a $58 raise. The same increase would give a member who retired in 1991, with the same years of service, whose pension averages $1,541, a $154 increase.

◗ Focusing ad hoc increases solely on inflation also ignores the growth in education salaries since the 1960s and early 1970s. For example, the statutory minimum pay in 1960 for a beginning teacher with a Bachelor's degree was $3,204 a year. Today this minimum has risen to $17,000—a 430 percent increase. Since retirement benefits are tied to salary, the low salaries of older long-term retirees continue to depress their benefits.

▼ **Raising the minimum payment directly increases the pensions of retirees with the lowest benefits.**

◗ The Legislature has enacted minimum annuities (annual benefit payments) for TRS retirees as a way of addressing the problems of inadequate pensions. The chart, *History of Minimum Annuities*, shows when these minimums were enacted, six times since 1955.

◗ Minimum annuity clauses in retirement programs can be used to establish a safety net for members based on their years of service. The TRS statute contains both an absolute minimum ($150 per month) and a minimum based on length of employment ($6.50 per year of service per month). Basing minimums on the number of years of service can ensure that career employees receive adequate benefits.

◗ The length of employment minimum—$6.50 per year of service—was last raised in 1971. Raising this floor to $34 per year of service would result in a minimum monthly payment for 30-year employees of $1,020—just below the average of all TRS retirees. This benefit would lift more than 6,000 TRS retirees above the poverty line and provide increases for 33,000 retirees.

▼ **While raising the minimum payment directly increases the pensions of retirees with the lowest benefits, granting an additional benefit increase based on inflation would aid all other retirees.**

◗ In 1993, the 73rd Legislature granted a 25 percent 'catch-up' pension increase that was conceived as a first installment in an effort to restore retirees to the purchasing power of their original pensions. Continuing this commitment would aid all retirees. The graph, *TRS Pension Increases Compared to Inflation*, illustrates the effects of inflation on the purchasing power of TRS pensions.

◗ Granting an increase to compensate for inflation would help retirees to keep their standard of living in line with rising consumer prices.

▼ **Both increasing the minimum benefits of career education retirees and granting a 25 percent of inflation catch-up pension increase is within the financial means of the Retirement Fund.**

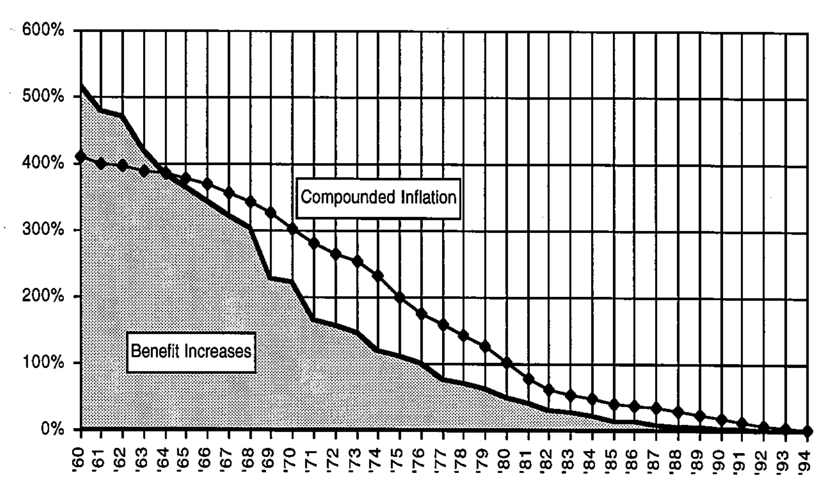
◗ Increasing the minimum annuity and an inflationary catch-up increase could be done even at or near the state's constitutional minimum contribution of 6 percent, according to the latest actuarial studies. The complete fiscal cost of this proposal is discussed in the fiscal impact section.

Conclusion

While the Texas Legislature has consistently given benefit increases, many retirees' pensions are below what is needed to provide an adequate standard of living. Since most career educators do not receive Social Security benefits, and are not part of another retirement system, their TRS pension is their sole source of income.

Although long-term retirees have benefited from legislated increases, the best way to focus benefit increases on the neediest

TRS Pension Increases Compared to Inflation

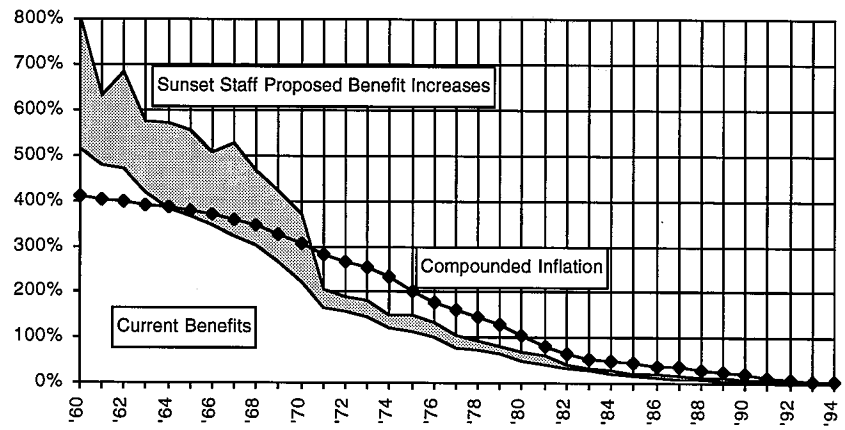


The Teacher Retirement Fund can afford more than twice the largest previous benefit increase in its history—even at the minimum contribution rate.

retirees is to increase the statutory minimum benefit. Increasing the statutory minimum based on the number of years of service would target long-term career educational retirees and ensure that this group has an adequate standard of living.

Granting retirees a pension increase based on inflation would help all retirees regain purchasing power lost to inflation. The chart, *Sunset Staff Proposed Pension Increases*, compares this proposal to inflation and current benefits.

Sunset Staff Proposed Pension Increases Compared to Inflation and Current Benefits



Recommendations

Changes in Statute

- **Raise the minimum retirement payment for present retirees to $34 per month for each year of service.**
- **Grant an increase in pensions for present retirees equal to 25 percent of the difference between their current pensions and the rate of inflation.**

These recommendations will increase retirement payments to present retirees whose salaries and corresponding retirement benefits did not feel the impact of the dramatic teacher salary increases of the 1970s and 1980s and would give all current retirees 25 percent of the purchasing power lost to inflation. Retirees would receive the higher of the two benefit increases. Raising the monthly minimum to $34 per year of service would increase a 30-year career teacher's retirement benefit to a minimum of $1,020 per month. The minimum would also apply to disability retirees, but not to members who chose reduced benefits through early retirement. The recommendations would preserve the System's actuarial soundness and still allow for future increases.

Provisions of the Internal Revenue Code may restrict tax-exempt pension plans from providing retirement benefits higher than the final salary of retirees after inflation. While federal legislation is being considered to remove this restriction for public pension systems, present law should not affect this proposal. Although the final average salary of TRS members with more than 30 years of service who retired in 1960 was $3,714, when adjusted for the 410.9 percent compounded inflation since 1960 the final average salary would be $15,261—$3,000 more than the minimum increase contained in this proposal. In addition, the statute currently allows the Trustees to amend the benefits plan if necessary to conform with IRS law and rules.

Fiscal Impact

The cost to a retirement system to institute benefit improvements is calculated in several ways: the annual cost, the actuarial cost (the amount to fund every beneficiary for their life expectancy), and the cost in terms of the funding period (the time it takes the system to pay for the benefits that are expected to be given in the future). Each of these costs must be determined by an actuary to ensure that the system is financially sound.

This proposal was examined by the actuarial firm of Coopers & Lybrand and was estimated to cost $248 million per year and to have an actuarial cost of $1.78 billion. This increase would be more than twice the largest previous increase in the history of TRS.

The true measure of the affordability of a benefit proposal is how many years it adds to the funding period. At the current state contribution rate of 7.31 percent of salary, this proposal will add 7.9 years to the base funding period to total 13.3 years—less than half the maximum period of 31 years. Depending on exact provisions of the increase, it could be granted even if the state contribution rate was lowered to near the constitutional minimum.

ISSUE 2

EXPAND THE TRS HEALTH INSURANCE PROGRAM TO COVER THE ENTIRE PUBLIC EDUCATION COMMUNITY.

BACKGROUND

Health Insurance for Public School Employees

Group health insurance for public school employees is the responsibility of individual school districts. A major study conducted in 1991 by the Commissioner of Education, the State Board of Education and the Teacher Retirement System recommended moving the provision of health insurance from the local school districts to a statewide program for district employees. The study recommended that all school districts be required to participate. However, due to state budget constraints, the mandatory statewide program was not established.

Instead, the 72nd Legislature, as part of House Bill 2885, mandated that local school districts provide a health insurance program comparable to that provided to state employees.

In 1993, in response to continuing concerns about the availability of health insurance for school district employees, the Legislature instructed TRS staff to study the need for a statewide health insurance program for current school district employees. The bill also required the agency to analyze the current statewide health insurance program for retirees—TRS-Care.

The bill, House Bill 2711, required TRS to recommend to the Legislature how to finance a contingency reserve fund—the money needed to be set aside by a health insurance plan to be sure enough cash is available to pay all claims.

TRS staff was to also recommend at least three options to minimize effects of what is called adverse selection against the program. Adverse selection occurs when an insurance plan allows anyone to enter or leave the program and more participants with high health care costs choose the group health insurance plan, driving up costs for each member of the group. TRS actually recommended only two options in its report—to either make a health insurance program mandatory for all school districts or make the program mandatory for an unspecified group of districts. The report did not discuss or recommend expanding

In response to continuing concerns about the availability of health insurance for school district employees, the Legislature instructed TRS staff to study the need for a statewide health insurance program.

TRS-Care to current school district employees.

House Bill 2711 required public school employees to pay a $10 annual fee to the agency to be used for start-up funds if such a program is created and to pay the cost of the study. At the end of fiscal year 1994, TRS had collected about $4.9 million from the fees and interest earned on the fees. TRS will collect an estimated $4 million in additional revenue from this year's $10 fee. The only expenditures from these revenues were for the required report to the Legislature discussed above. TRS spent $41,500 for the study. The $10 fee will be returned or credited to the members if a health care program is not created.

A 1991 study showed that about 13 percent (132) of the state's school districts did not offer group health insurance.

Health Insurance for TRS Retirees

Because most retirees did not have health insurance or qualify for Medicare, the Legislature created the TRS-Care health insurance program in 1985.

TRS-Care provides free, catastrophic insurance coverage to retirees. TRS Trustees have added enhancements to the basic catastrophic coverage paid for by premiums from retirees choosing enhanced coverage. One of these enhancements, called TRS-Care 3, provides comprehensive health care coverage with a low annual deductible.

The TRS Trustees have privatized administration of the health plan by contracting with Aetna insurance company to conduct day-to-day activities of the program such as paying retirees' claims and precertifying medical procedures.

The Legislature, current public school employees, and retirees jointly fund the TRS-Care program. The Legislature provides a contribution of 0.5 percent of school district employees' salaries which totaled about $56.9 million in fiscal year 1994; employees contribute 0.25 percent of salary which totaled about $28.5 million; retirees contribute premiums if they choose enhanced options or family coverage. Retiree premiums totaled about $73.5 million in fiscal year 1994. TRS-Care had 93,162 retirees enrolled and a fund balance of $225 million. A detailed discussion of the TRS-Care program can be found in the background section of this report.

FINDINGS

▼ **Prior research efforts indicated gaps in health care availability for school district employees.**

- A 1991 study by the Texas Education Agency and TRS found that 132, or about 13 percent, of the state's 1,066 school districts did not offer group health insurance. This figure included about 7,500 employees not offered health insurance through their districts. A majority of those districts without health insurance indicated that coverage was not offered due to the cost.

- **The recent TRS study shows that health insurance is still not available or comprehensive in some districts.**

  - According to the 1994 TRS survey, 16 school districts still do not offer health insurance. In many other districts, health plans provide significantly fewer benefits than the standard (equal to state employee health benefits) set in House Bill 2885.

  For example, the standard state employees' plan has unlimited lifetime benefits—the plan will pay for the cost of an illness or injury regardless of how much it costs over time. However, only 297 school districts offer unlimited lifetime benefits.

- **The 1994 TRS health insurance survey shows an interest on the part of school districts and employees for a statewide health insurance program.**

  - Almost half of the responding school districts (42 percent) indicated interest in a voluntary statewide health insurance plan even if the plan had restrictions on enrollment to limit adverse selection.

  - More than three-quarters of employees (77 percent) responding to the survey favor a statewide plan if the districts pay most of the costs. Twenty-two percent of TRS members now in a school district-sponsored plan were not satisfied with their plan. Although the TRS survey of employees shows trends, it is not considered statistically valid because it failed to obtain enough responses from this group.

  - Almost one-third (30 percent) of employees responding to the survey support a mandatory statewide heath insurance plan even if state funding is not available. While subject to the limitations of the survey mentioned above, this response appears to show a willingness on the part of some employees to pay a portion of the costs of health insurance if a plan were offered.

- **School district employees have a strong interest in**

Most recent studies indicate that affordability and availability of comprehensive health coverage is inadequate for school employees.

joining a health insurance plan that includes retirees.

- The TRS study showed that nine out of 10 school district employees responding favor a statewide plan that includes retirees.

▼ **The TRS-Care 3 program could be certified as comparable to the health insurance program provided to state employees.**

- Current law requires school districts to certify that they provide health insurance comparable to the state employees' health insurance program operated by the Employees' Retirement System.

- The TRS-Care 3 retiree plan provides comprehensive health care coverage that includes hospital and physician provider networks that have entered into contracts with TRS-Care to provide services at contracted rates and a network of pharmacies.

- Other significant similarities between the plans include deductibles, prescription drug benefits and precertification requirements.

- TRS staff indicate that TRS-Care 3 could be certified as comparable to the state employees health insurance plan if offered to school district employees.

CONCLUSION

Over the past few years, successive studies have looked into improving the availability and affordability of health insurance for school district employees. Most of the results indicate that affordability of insurance and availability of comprehensive coverage are inadequate.

The 1994 TRS survey showed that there is significant interest in a statewide health insurance program for school district employees. However, as was the case in previous years, the state budget is tight and there are many requests for what funds are available.

TRS presently runs a health care program for retirees. The TRS-Care program offers comprehensive group health insurance similar to that offered to state employees. TRS-Care could be made available to the employees of school districts in addition to the retirees in the plan while the existing program continues.

Recommendations

Changes in Statute

- **Provide TRS Trustees authority to offer TRS-Care 3 to school districts for their employees. TRS Trustees may:**
  - **limit the rate of school districts entering the program as necessary to maintain its financial stability, based on criteria set by the Board before expansion proceeds;**
  - **limit school districts' entry into and exit from the program to controlled "open enrollment or disenrollment" periods;**
  - **cover administrative costs with fees charged to participating districts; and**
  - **establish rules as necessary to minimize effects of adverse selection into and from the program and to administer the program.**
- **In addition the statute should:**
  - **allow school districts to participate if they agree to pay employee-only costs at least up to the amount the state pays per employee for state employee health insurance, unless TRS Trustees set employee-only premiums lower than this cost;**
  - **require total premiums from districts and employees to defray all costs of school district employee participation in TRS-Care;**
  - **transfer all proceeds from the $10 health insurance annual member fee to TRS-Care to help finance larger contingency reserves necessary for the addition of active TRS members to the TRS-Care program; and**
  - **discontinue the fee after 1996.**

Under this approach, current TRS-Care funding for retirees is not affected or changed. The agency would be required to charge premiums to cover all costs of adding school district employees to the program. However, retirees could potentially see expenses reduced as TRS-Care takes advantage of greater volume to gain better discounts and negotiated rates from health care providers.

In addition, adding a large number of current school district employees to TRS-Care will make the overall composition of the group younger and healthier, which should also reduce costs for all current participants. Essentially, the effect would be the opposite of adverse selection—with lower cost participants joining the group plan.

About 57,560 retirees are now enrolled in TRS-Care 3. While offering this option to school districts would significantly increase the size of the program, the agency could offer the TRS-Care option first to districts most in need of quality employee health care plans. This approach would control growth of the program through a phased expansion period.

This recommendation will not expand the TRS bureaucracy. The TRS Trustees have privatized the TRS-Care program. Aetna insurance company has the contract to operate TRS-Care. The agency should keep the program in private hands by simply expanding the contract to include services for active school district employees.

The recommendation would continue the Legislatures's approach of ensuring parallel health benefit coverage between state employees and employees of local school districts. Although the statute presently requires districts to offer a health plan similar to the state employee plan, not all districts have been able to do so. This recommendation would ensure that districts have such an option available.

Management Action

- **TRS should continue to assess school district and employee interest in participating in a health insurance program such as TRS-Care and, as directed by statute, develop and present options for districts interested in enrolling their employees in TRS-Care.**

Fiscal Impact

This recommendation would not result in a fiscal impact to the Retirement Fund or the state, although supplementing funds to all retirement programs are legislative budget options.

Balances now held in the TRS-Care fund, along with funds transferred from the $10 annual fee on school district employees, would provide a start-up contingency reserve for the program. After September 1, 1995, at least $15 million would be available from the annual fees to provide the initial reserve. According to the TRS study, $25 million would be a sufficient reserve to provide for 61,000 participants.

In addition, holding money in reserve does not mean it will be spent. The money is held in case expenses exceed premiums collected. If the program had to use any contingency reserve funds, the recommendation would require the funds to be repaid from higher premiums charged to participants. After the program was in place, premiums would be more accurately set based on experience with the group and the need for a large contingency reserve would be reduced.

Administrative costs to TRS-Care would be covered by the authorization for an administrative fee on districts choosing to participate. This fee would be needed because TRS cannot spend retirement trust funds on the health insurance program. However, a primary advantage of opening TRS-Care to school districts is that it builds on the extensive program already in place and limits start-up expenses normally associated with developing a new plan.

School districts choosing to participate could see either lower or higher costs depending on their current health insurance premiums and the share paid by the district and employees. Under this recommendation, school districts choosing to participate in TRS-Care would need to bear the employee-only costs up to the amount the state pays toward health care for its employees unless the TRS-Care premium is less than this amount. The state's monthly per-employee contribution for health insurance is $195.82 for fiscal year 1995.

ISSUE 3

IMPROVE MONITORING OF INVESTMENT PERFORMANCE FOR TRUSTEES AND THE LEGISLATURE.

BACKGROUND

The Constitution directs the Board of Trustees to administer and invest the Retirement Fund (Fund) in a prudent manner.

The Fund receives revenue from three main sources: member contributions; state contributions; and earnings on investments. The System uses these funds to pay benefits, operational costs, and to invest to provide for future benefits. The chart, *Texas Teacher Retirement Fund Time-Weighted Rate of Return*, shows Fund earnings over the past 10 years.

The Legislature has given Trustees broad investment authority to purchase stocks, bonds, mortgage backed securities and to hold funds in cash. By law, Trustees are subject to the "prudent person" rule and are required to invest the Fund as they would invest their own money.

Investment earnings made up 70 percent of revenue to the Fund in fiscal year 1994. Because investment earnings make up such a large percentage of revenue, it is critical to maintain a high rate of return with an acceptable level of risk.

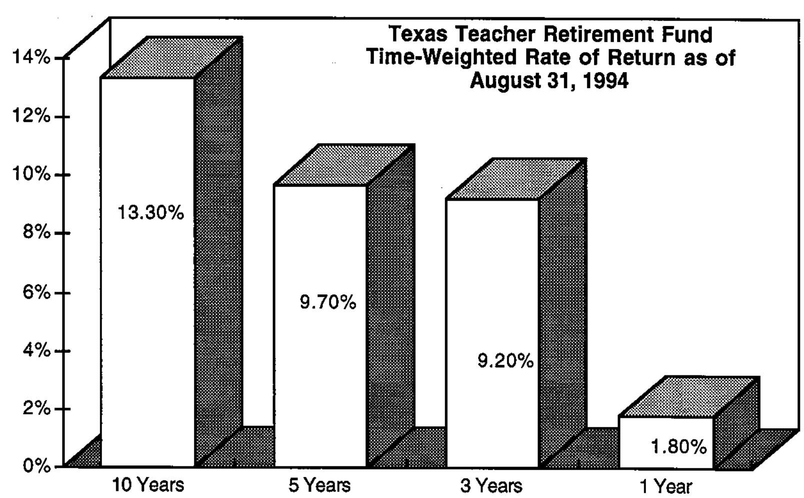
The Legislature is responsible for both the financial health of the Fund and for setting TRS retirement benefits, and thus has a duty to monitor the financial health of the System, including investment performance.

The Legislature is responsible for both the financial health of the Fund and for setting TRS retirement benefits.

FINDINGS

▼ **The Legislature is ultimately responsible for the financial health of the Retirement Fund and its ability to pay retirement benefits.**

◗ The Constitution obligates the Legislature, and therefore, the taxpayers of Texas, to pay



Dependence on investment earnings will grow in the future as the population ages and demands on the Fund increase.

TRS retirement benefits to members. If for any reason the financial health of the Fund was threatened, the Legislature would be required to increase contribution rates to pay retirement benefits.

- The state contribution to the Fund is the second largest source of revenue, exceeded only by investment earnings from accumulated legislative and member contributions. The Legislature appropriates almost $1 billion of taxpayer money each year to ensure that sufficient funds are available to pay retirement benefits to the retired teachers of Texas.

▼ **Earnings from the investment of state and member contributions are critical to the financial health of the Fund.**

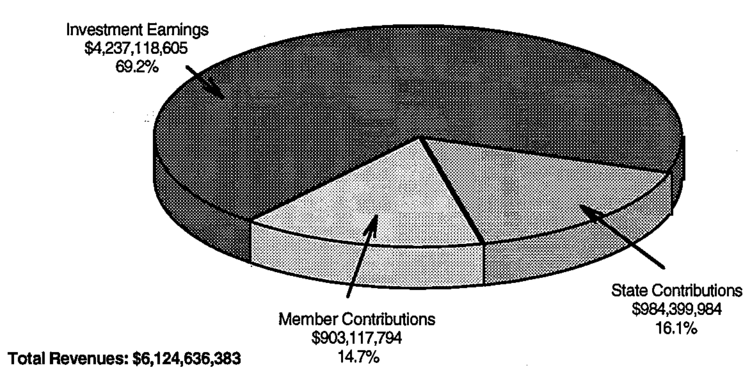
- Earnings from the investment of state and member contributions are the largest source of revenue to the Fund totaling more than $4.2 billion in fiscal year 1994, as shown in the chart, *Sources of Revenue*. These investment revenues result from the gains on the sale of investments, and interest, dividends or other income from investments.

- Earnings from investments can directly affect the level of member and state contributions. If investment earnings decreased, the state could be required to adjust state and member contributions to fund benefits. Falling investment earnings could also reduce the level of future benefit increases.

▼ **Dependence on investment earnings will grow in the future as the population ages and demands on the Fund increase.**

- Because the amount of money required to pay benefits is projected to exceed income from state and member contributions by 1995, monitoring the performance of Fund investments becomes more critical. The situation where benefits exceed contributions is not a cause for

Sources of Revenue to the Teacher Retirement Fund
Fiscal Year 1994



concern and is common in maturing pension funds, but it does place an increasing burden on investment earnings.

- TRS officials have computed that the number of retirees will grow almost three times faster than the number of members paying into the system. By 2015, the number of active members per retiree will drop from 4.4 to 2.5. This changing ratio of active members to retirees will also lead to heavier reliance on investment income.

▼ **The Fund's recent investment returns have been below expectations.**

- The market value of the Fund grew less than 2 percent during fiscal year 1994—well below the Fund's projected rate of return of 8 percent.

- While failure to meet the expected rate of return for one or two years is not a serious problem, failure to meet the expected rate for several years reduces the ability of the Legislature to provide benefit increases and could require the Legislature to increase contributions to meet future benefit requirements.

- The consultant that measures the Fund's investment performance reports that for the four quarters from October 1, 1993 through September 30, 1994, the market value of the Fund suffered a loss of approximately $200 million dollars, which represents a .5 percent loss in the market value of the Fund. Market value does not represent the realized value of the Fund, but is a snapshot of the Fund on a particular day.

- The Fund has booked losses of $209 million on real estate mortgages for properties foreclosed to date. In addition, TRS incurred losses of $35.8 million when it foreclosed on a building in downtown Austin. In addition to this loss, TRS spent another $35.2 million repairing this property so that the building is leaseable. The Trustees maintain that real estate losses will be recovered in time.

- The market value of several properties securing active mortgage loans is $253 million less than the loan amounts themselves. In addition, the agency indicates in its loan status report that 75 percent of present real estate loans could pose problems in the future. However, the agency responded that income from the mortgages has outpaced losses on the underlying real estate.

The market value of the Fund grew less than 2 percent during fiscal year 1994—well below the Fund's projected rate of return of 8 percent.

The May 15, 1994 *Houston Chronicle* reported, "The Teacher Retirement System of Texas has lost enough money on the value of its real estate to fund a 5 percent pay raise for all the state's teachers and to give each of its members a cash bonus of $400."

- Although these losses do not threaten the solvency of the Fund or its ability to pay benefits to its members, they are an indicator that investments should be carefully monitored.

- Attorney General Dan Morales identified concerns about TRS' real estate investment practices in a report issued March 11, 1993. The report concluded,

> "We have grave concerns about the current condition of the System's real estate portfolio and about the ability and integrity of the current staff who manage it. We urge the Board to conduct a thorough forensic audit of the real estate portfolio (something Coopers & Lybrand has not been retained to do) and to investigate claims it may have against certain of the institutions and individuals mentioned in this report. Finally, we strongly urge the Board to review all its policies with respect to real estate to see that these policies are consistent with the System's investment authority, and that the portfolio is handled in a prudent, fiscally conservative manner, consistent with the directives in the Texas Constitution."

TRS hired Coopers & Lybrand to conduct a forensic "review" of the real estate program and has worked with the Attorney General to address other concerns. TRS also modified the real estate program to provide more control to the Trustees and created a real estate committee.

- In the summer of 1994, the Attorney General turned over documents to the District Attorney for further review. Travis County District Attorney Ronnie Earle said November 23, 1994,

> "Issues raised in the Attorney General's report and the private audit performed by TRS have not answered the question of criminal liability. However, much like savings and loan investigations, a team of auditors and attorneys would be required to fully investigate and unravel all the financial information and make a final determination of criminal liability. At this time, the District Attorney does not have the auditing staff to do such an in-depth financial investigation in its general state division of the public integrity unit."

- The May 15, 1994 *Houston Chronicle* reported, "The Teacher Retirement System of Texas has lost enough money on the value of its real estate to fund a 5 percent pay raise for all the state's teachers and to give each of its members a cash bonus of $400." The article went on to say "TRS officials argued that income from the mortgages has outpaced losses on the underlying real estate."

◗ The Fund can be a patient investor. Liabilities are counted in decades. A $38 billion fund can ride through market cycles. The primary aim of any such fund is to capture gains when the market is rising, minimize losses when the market falls, and diversify so as to cover both sides of business cycles.

▼ **The Legislature and Trustees have no independent oversight of the performance of Retirement Fund investments.**

◗ The state has never conducted an independent evaluation of the Fund's investment performance.

◗ While the Fund uses two firms, Holbein, Inc. and the Wellington Management Company, to provide evaluation and analysis of investment performance, these organizations are hired by the Trustees and work closely with TRS staff. In fact, Wellington Management Company, the Fund's outside investment counsel, has been employed by the Fund for 14 years.

◗ The National Conference of State Legislators (NCSL) in *Public Pensions, A Legislator's Guide,* recommends that state legislatures should regularly review management and investment polices, since state legislators bear ultimate responsibility to voters and beneficiaries for the financial security and well-being of retirement systems.

▼ **The Legislature does not receive timely, comparable information on the investment performance of state pension systems.**

◗ It is difficult to gauge investment performance without comparisons to other public pension systems. Texas state pension systems are not required to develop and report such comparisons.

◗ In 1994, the State of Minnesota passed legislation requiring public pension systems to report investment performance at the same time and in a uniform manner.

◗ While the Teacher Retirement System is required to file an investment report with the Legislative Budget Board (LBB) each year, it is not required to report on a specific date. In comparison, the statute requires the Employees Retirement System (ERS) to submit a report 25 days after the end of the fiscal year.

Information on the exact market value of the Fund was not available until more than 60 days after the end of the fiscal year.

The Legislature needs to know whether the investment of $35.8 billion in stocks and bonds and $1.7 billion in real estate is being maximized.

- The process used by the Trustees to get information on investment performance is cumbersome. Holbein, Inc., the hired investment performance consultant, obtains and analyzes investment data from the agency. Holbein, Inc. then reports its performance findings to Wellington Management Company, who in turn, summarizes the findings and reports to the Trustees.

- This process clearly does not result in timely dissemination of information. Information concerning the investment performance and the exact market value of the Fund was not available until more than 60 days after the end of the fiscal year. On September 30, November 3, and November 4, 1994, the agency provided Sunset staff with market values for the Fund which differed by $700 million. The correct figure was verified on November 7.

▼ **Independent evaluation of investments is needed to allow the Legislature and Trustees to adequately monitor investment performance and safeguard members' money.**

- Considering that the agency is in the process of restructuring their investment portfolio, an independent examination of that process and the portfolio could yield significant additional savings or greater returns for the members' Retirement Fund.

Investing a $38 billion fund is a complex process. The Trustees are responsible for setting long-range investment policies and on a daily basis are responsible for the investment of $35.8 billion in stocks and bonds and the management of $1.7 billion in real estate holdings. The Legislature needs to know that all these investments are being maximized.

- On September 1, 1994, the Trustees eliminated the investment advisory committee (IAC) that provided independent information on investment strategies and performance. The Trustees replaced IAC with an investment committee composed of the whole Board. The Trustees now receive investment information from agency staff and outside investment and real estate advisors.

- An independent review of Fund investment performance would not restrict the ability of TRS Trustees to select their own measurement service or outside advisors. An independent review could provide new ideas and approaches for Trustees to use in making decisions about the Fund on behalf of the membership.

- The Legislature already receives information on other facets of TRS performance. For example, the State Auditor's Office examines financial records and evaluates management performance.

Conclusion

To perform its duties, the Legislature needs independent, professional information in a timely manner that it can use in assessing the overall investment performance of the Fund. This information can be used to assist the Legislature in making decisions about meeting the future obligations of the Fund, proposing future benefit increases, determining state and member contributions, and finally, ensuring the health of the Fund and its ongoing ability to pay retirement benefits. In addition, uniform reporting will assist the Legislature in comparing the performance of the public pension systems it is required to fund.

An independent analysis of investment performance will also provide TRS Trustees with an external check on internal staff recommendations concerning investment decisions and a comprehensive review of the investment process.

Recommendations

Changes in Statute

- **Require the agency's investment practices and performance to be evaluated by an independent firm selected by the Legislative Audit Committee (LAC). In addition:**
  - **Require the evaluation to be submitted to the LAC by December 1 of even numbered years;**
  - **Authorize the LAC to determine the scope of the evaluation, although the first evaluation should be a comprehensive analysis of TRS' entire investment program; and**
  - **Require TRS to pay the costs of the independent evaluation.**
- **Require state retirement funds to submit their annual investment performance report to the Legislative Budget Board (LBB) in a format based on recommendations of the independent firm within 25 days of the end of each fiscal year.**

The intent of the recommendations is to provide independent information to the Legislature in a timely manner. The recommendation would provide the Legislative Audit Committee, and therefore the Legislature, with an independent evaluation of Fund investment practices and performance. The evaluation should include a comparison of the TRS Fund to similar pension funds, an analysis of investment performance over different time frames and during differing economic periods, and an examination of investment practices and techniques. The evaluation could also be used to address the concerns of the Attorney General's Office and the District Attorney. The evaluation also needs to look at the Fund's long-range investment goals and strategies.

Because the Legislative Audit Committee is composed of the Lieutenant Governor, the Speaker of the House, the Chair of the Senate Finance Committee and the Chair of the House Appropriations Committee, information on investment performance could be incorporated into the decision making process on state contributions. This information could also be used by the Legislature to establish a funding plan to meet the long range needs of the Retirement Fund.

Requiring the evaluation to be presented to the Legislative Audit committee by December 1 of even-numbered years will allow the Legislature to have this information well before the beginning of each legislative session.

Because there have been no independent evaluations of the Retirement Fund's investment performance in the past, the initial evaluation should be comprehensive. Subsequent reviews could target specific concerns of the Legislative Audit Committee.

The recommendation, requiring the annual investment report to the LBB to be submitted within 25 days of the end of each fiscal year, would make TRS' reporting requirements consistent with those of ERS and provide the LBB, Pension Review Board, and Legislature with more time to examine the Retirement Fund's investment performance.

Fiscal Impact

These recommendations would result in a minimal cost to TRS. The cost of contracting for an independent firm would be paid by TRS and cannot be estimated at this time. There would be no cost to the General Revenue Fund. Although TRS would incur some cost, it should be noted that any increase in rates of return due to the increased knowledge of managing investments could have a significant positive fiscal impact on the Fund.

ISSUE 4

BRING MORE BUSINESS EXPERTISE TO THE BOARD OF TRUSTEES.

BACKGROUND

The Teacher Retirement System (TRS) is governed by a nine-member Board of Trustees. All Trustees are subject to Senate confirmation and serve staggered six-year terms. The Texas Constitution requires the Trustees to administer the Teacher Retirement System and invest the funds of the System in a prudent manner. As required by statute, Trustees adopt and develop rules, approve the agency's operating budget, select advisors and consultants, and hire the executive director of the agency.

The primary duties of the Trustees are related to the investment of the $38 billion Retirement Fund. The Trustees approve the actuarial assumptions which determine the future costs of benefits, hire actuaries and other financial experts, and develop a list of stocks approved for purchase.

The structure and membership of the TRS Board is shown in the chart, *Composition of the TRS Board of Trustees*.

The Governor appoints seven of the nine Trustees.

- Of those seven, three Trustees are direct appointments, none of whom can be members of the System, with two having financial expertise and broad investment experience, preferably in investment of pension funds.
- Four Trustees—two active public school employees, one retiree, and one active employee of higher education—are nominated by their peers through elections. The Governor then makes the appointments from the three nominees receiving the most votes.

The State Board of Education appoints the two remaining Trustees.

This combination election/appointment process was established to provide a direct line of accountability from the appointees to the Governor, and therefore to the people of Texas.

Only two of the nine Trustees must have investment experience.

FINDINGS

▼ **Although the Trustees are responsible for investing the $38 billion Retirement Fund, only two of nine Trustees must have investment experience.**

- The Trustees are responsible for an enormous sum of money. The $38 billion Retirement Fund is more than all state agencies in Texas spend in a single year to provide all state services.

- A change in the investment rate of return of one one-hundredth of one percent can result in the gain or loss of $3.8 million.

- Having only two of the nine Trustees with demonstrated financial expertise concentrates a large amount of responsibility with two members.

- Other Trustees are not required to have training or practical experience managing a multi-billion dollar portfolio.

▼ **The Trustees recently abolished the external advisory committee that provided financial expertise to the Board of Trustees.**

- Effective September 1, 1994, the Trustees eliminated

Composition of the TRS Board of Trustees

Three members appointed directly by the Governor. Two of these members must have demonstrated financial expertise, have worked in private business or industry and have broad investment experience, preferably in dealing with pension funds.

- *Frank W. (Bo) Camp, Kilgore (Retired Businessman)*
- *Ronald Steinhart, Dallas (Businessman)*
- *Dr. Kneeland Youngblood, Dallas (Physician)*

Two members appointed by the Governor from among three elected nominees of active TRS members employed by a public school district.

- *Charlsetta Finley, El Paso (Teacher)*
- *Sue McGarvey, Longview (Counselor)*

One member appointed by the Governor from among three elected nominees of retired TRS members.

- *Dr. Lee Williamson, Wichita Falls (Retired Superintendent)*

One member appointed by the Governor from among three elected nominees of TRS members employed by a public institution of higher education.

- *Dr. Kathryn Stream, Houston (Executive Director, Texas Women's University Health Science Institute - Houston)*

Two members appointed by the State Board of Education.

- *George M. Crowson, Pasadena (Retired Superintendent)*
- *Dana Williams (Chair), Corpus Christi (Retired Superintendent)*

the investment advisory committee (IAC). The IAC provided the Trustees and staff with outside investment advice on portfolio structure, stocks and bonds, and investment strategies. The committee was composed of five to nine private sector investment professionals. These professionals were typically officers of investment companies.

◗ The Trustees created an investment committee composed of the whole board to replace IAC. There are no outside investment professionals which sit permanently on the committee. If the committee is unable to get needed financial advice from staff, it can contract for outside expertise on a consultant basis. The Trustees are in the process of selecting two equity/fixed income consultants and three real estate consultants to provide investment information to the committee, but none has been selected to date.

▼ **The growing reliance on investment earnings makes the management and investment of the Retirement Fund more critical to the health of the System.**

◗ Projections indicate that retiree benefits and System expenses will exceed state and member contributions for the first time in fiscal year 1995. Although benefits exceed contributions in many pension systems, this situation puts additional pressure on investment earnings. Investment earnings are the single largest source of income to the Retirement Fund and are needed to maintain the health of the System.

◗ The growing importance of investment income places even greater pressure on the Trustees to make knowledgeable investment decisions.

▼ **Other states require statewide retirement systems to have stronger investment expertise on their boards.**

◗ Other states require some degree of investment experience on their retirement system boards.

- California requires the State Comptroller and the Treasurer to sit on the board of both its public employees and teacher retirement systems;

- Georgia requires the director of the Office of the Treasury and one public member with investment experience to sit on the board of its teacher retirement system;

The Trustees eliminated the investment advisory committee that provided outside investment advice.

State legislatures bear ultimate responsibility to the voters and beneficiaries for the well-being of state retirement systems.

- New York has one trustee, the State Comptroller, comprising the entire board of its state and local retirement system;

- Pennsylvania has its State Treasurer on the board of its public school employees retirement system, and

▼ **Although the Legislature is responsible for maintaining the health of the Retirement Fund, the presiding officers of the Senate and House of Representatives have no present role in appointing Trustees.**

◗ State legislatures bear ultimate responsibility to the voters and beneficiaries for the financial security and well-being of state retirement systems.

◗ Allowing the Lieutenant Governor to appoint Trustees and allowing the Speaker of the House of Representatives to nominate Trustees for appointment ensures that those Trustees understand the concerns of the Legislature, which is ultimately responsible for the financial security of the System. If the System faced financial difficulties, the Legislature would be responsible for appropriating money to keep the System sound.

▼ **Because Texas Education Agency employees no longer participate in TRS, appointment of two Trustees by the State Board of Education may no longer be appropriate.**

◗ In 1993, the Legislature authorized the educational employees of several agencies to transfer their retirement credit from TRS to the Employees Retirement System (ERS). The State Board of Education chose to transfer its Texas Education Agency (TEA) employees to ERS under this authorization. Appointment provisions have not been changed to reflect this transfer.

Conclusion

Most TRS Trustees do not have extensive financial or business expertise, even though the primary duty of the Trustees is to prudently invest a $38 billion Retirement Fund. Instead, the current structure focuses on ensuring education and retiree representation on the Board. However, the need for Trustees of this System to have financial or business expertise is critical because of the complexity of managing the fourth largest public pension fund in the United States. The Trustees also must understand and approve complex actuarial assumptions and investment strategies. Increasing financial expertise will help ensure the Trustees make the best decisions possible.

Recommendations

Changes in Statute

- **Require all three direct Governor appointees to have financial and investment expertise.**
- **Replace the two appointments by the State Board of Education with two appointments by the Lieutenant Governor that must:**
  - **have financial and investment expertise and**
  - **be related to a member of the system.**
- **Require that one of the Governor's appointments and one of the Lieutenant Governor's appointments be made from a list of nominees submitted by the Speaker of the House.**

The strength of a pension system board lies in its ability to make wise investment and management decisions. These recommendations will result in greater financial expertise among the Teacher Retirement System Board of Trustees without reducing the number of seats dedicated for members of the System.

As the Retirement Fund's dependence on investment earnings grows, this change in Board structure will help the Board focus on its constitutional duties to productively invest the assets of the Retirement Fund and effectively administer benefits. Such expertise will allow for greater scrutiny of staff recommendations and understanding of complex investment issues.

In addition, requiring Trustees appointed by the Lieutenant Governor to be related to a member of TRS will further ensure that the best interests of the members are taken into account by the Trustees.

The process for appointing the four Trustees nominated by their peer groups would remain the same. To minimize the disruption of Trustee activities, the TRS Board of Trustees should be reconfigured as the current members' terms expire.

Fiscal Impact

These recommendations would not result in a cost to the Retirement Fund or state. However, this recommendation should result in greater investment returns and therefore enhance the security of the Teacher Retirement System.

ISSUE 5

INCREASE LEGISLATIVE OVERSIGHT OF TEACHER RETIREMENT SYSTEM'S OPERATING EXPENSES TO ALLOW EDUCATORS' MONEY TO BE USED SOLELY FOR MEMBER BENEFITS.

BACKGROUND

The appropriations process is the primary tool state government uses to save and direct scarce state funds.

Although the Teacher Retirement System (TRS) receives a constitutionally mandated appropriation to help pay benefits, TRS operating expenses are not appropriated by the Legislature and are paid directly from the Retirement Fund. In addition, TRS is not subject to the strategic planning and performance budgeting system or administrative guidelines in Article V of the General Appropriations Act.

The state planning and performance budgeting system is used to evaluate agency performance and Article V guidelines provide agencies with standards for efficient and effective business practices.

In fiscal year 1994, the Retirement System spent $26.3 million of members' money in budgeted operating expenses and $931,000 for TRS-Care operating expenses. However, actual System expenses were much higher. In addition to the $27.2 million in budgeted operating expenses, the System indirectly paid $23 million in brokerage fees that included $2 million for additional services provided by brokers. Fees for these services, known as soft dollar expenditures, are not reported in the operating budget and are paid directly out of investment earnings, as are the brokerage fees. TRS also spent $55.8 million on the management and operation of foreclosed properties and $3.7 million for advisors on real estate loans. These real estate expenditures are not detailed in the operating budget but are accounted for as investment expenses and offset against Fund investment income.

Until the 1960-61 biennium, the Legislature appropriated funds to TRS for operating expenses such as agency salaries, travel, rent, and other expenses.

In recent years, the operating budget has been approved by the Board of Trustees without additional oversight. The Trustees have not adopted performance budgeting. In fact, the TRS executive director has referred to

TRS spent more than $27.2 million in operating expenses from members funds without standard legislative oversight.

Brokerage commissions rose 155 percent to $23 million in 1994.

the state government performance based budgeting as "bureaucratic gobbledygook."

Today, more than $27.2 million in budgeted dollars per year, plus unbudgeted investment expenses of $82.5 million—all members' funds—are being used to run TRS without standard legislative oversight.

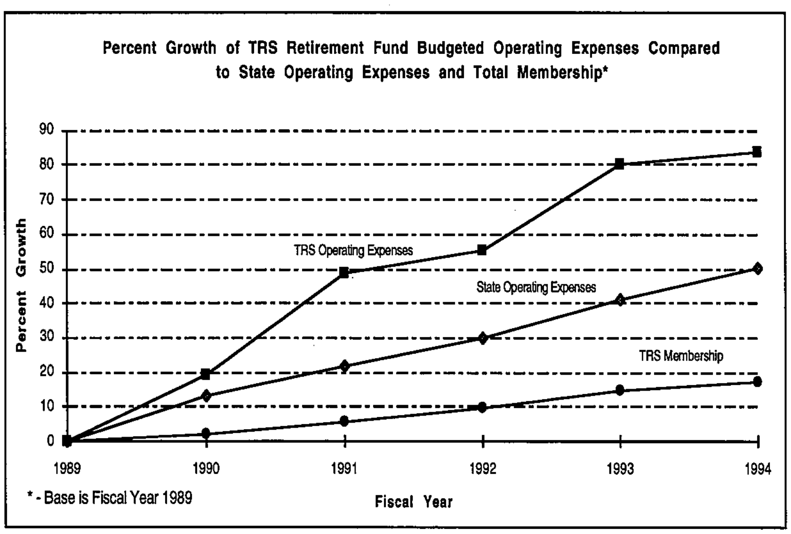
FINDINGS

▼ **Without legislative oversight, TRS members are paying for rapidly increasing operating expenses from funds that could otherwise be used to pay benefits or increase investments.**

- While active members pay $10 each per year toward operating expenses, TRS spends approximately $44 per active member for budgeted operating expenses. The difference between the total fees paid by active members and budgeted operating expenses is approximately $20 million. This difference represents investment income that would otherwise be available to pay benefits or increase investments.

- TRS operating expenses have increased 83.5 percent since fiscal year 1989. The chart, *Percent Growth of TRS Retirement Fund Budgeted Operating Expenses*, shows that TRS operating expenses are increasing significantly faster than statewide operating expenses or growth in System membership.

- This dramatic increase in operating expenses does not include TRS-Care, brokerage commissions, real estate expenses, or soft dollar expenditures.



TRS expenditures for brokerage commissions totaled $23 million in fiscal year 1994, or an increase of 155 percent from 1993.

Included in brokerage commissions are $2 million in soft dollar services. These expenditures are for services provided by brokers in addition to their normal stock trading services. Because costs for these additional services are included in the brokers' fees for trading stocks, they are not shown as an operating expense in the TRS budget. While this practice is common among pension funds, there is no system in place for current and future retirees to know how much of their money is used to cover these expenses or what services are being bought.

In addition, TRS expenditures for the operation and management of foreclosed properties and real estate advisors totaled $59.5 million in fiscal year 1994. This included taxes and insurance, plant operations, operating expenses for real estate subsidiaries, and fees for real estate advisors.

▼ **TRS spent a higher percentage of total expenditures on operating expenses than other large public pension funds in the nation.**

◗ In 1992, 12 of the nation's 15 largest public pension funds were subject to some form of legislative operating budget oversight or authorization.

◗ Based on 1992 data, the percentage of total expenditures spent on operating expenses for public pension funds with legislative budget oversight averaged 24 percent less than those with legislative budget oversight.

◗ Legislative oversight of operating expenses could save members' money through greater operating efficiency. An analysis, based on 1992 data, of other public pension funds with legislative oversight, showed that TRS retirees and future retirees could have saved approximately $2.7 million in fiscal year 1992. Similar savings would be expected in subsequent years.

◗ Of the 15 largest public pension funds, TRS had the sixth highest percentage of expenditures used for operating costs. These rankings are shown in the chart, *Comparison of Public Pension Fund Ranked by Percentage of Operating Expenses*.

▼ **Prior management reviews of TRS by the State Comptroller and State Auditor have consistently identified high operating expenses as an area of concern.**

◗ The 1992 State Auditor's management audit of TRS observed that operating expenses were increasing an average of almost 10 percent

80 percent of the nation's largest public pension funds are subject to legislative oversight. Savings averaged 24 percent.

per year, that there were dramatic increases in operating expenses per member, and that TRS was continually budgeting more funds for operations than was required.

- In 1991, the State Comptroller awarded TRS the Silver Snout award for extravagantly furnishing its new staff headquarters using members' dollars.

- In *Breaking the Mold*, the 1991 Texas Performance Review, the State Comptroller questioned TRS management of operating expenses. Specifically, the report noted that from fiscal year 1981 to 1990, TRS operating expenses grew six times faster than system membership.

- The report concluded that legislative oversight of the pension fund would lead to greater efficiency in the administration of the retirement system and recommended that operating expenses be appropriated by the Legislature.

These recommendations were not adopted because of

Comparison of Public Pension Funds Ranked by Percentage of Operating Expense

System	Budget Oversight	Rank by Fund Size	Size of Fund (MV)	Operating Expenses	Total Expenses	Operating Expense Percentage
Ohio State Teachers' Retirement System	Board	6	$26.9 billion	34,129,000	1,278,460,000	2.67%
Oregon Public Employes' Retirement System	Legislative	13	$14.1	10,282,000	567,866,000	1.81%
New York State & Local Employees Retirement System	Legislative	2	$53.4	36,619,000	2,232,257,000	1.64%
California Public Employees' Retirement System	Legislative	1	$74.2	50,079,000	3,246,123,000	1.54%
Pennslyvania Public School Employees' Retirement Plan	Legislative	10	$21.4	15,723,000	1,078,508,000	1.46%
Teacher Retirement System of Texas	**Board**	4	**$33.1**	**22,000,000**	**1,513,000,000**	**1.45%**
California State Teachers' Retirement System	Legislative	3	$40.8	27,531,000	1,914,257,000	1.44%
Virginia Retirement System	Legislative	12	$14.1	9,693,000	690,092,000	1.40%
Pennslyvania State Employees' Retirement System	Legislative	15	$13.0	11,501,000	881,042,000	1.31%
Public Employees' Retirement System of Ohio	Board	8	$26.6	16,178,000	1,310,524,000	1.23%
Florida Retirement System	Legislative	5	$28.6	10,467,000	1,008,337,000	1.04%
Michigan Public School Employees' Retirement System	Legislative	11	$16.4	9,484,000	1,031,567,000	0.92%
Teachers' Retirement System of Georgia	Legislative	14	$13.8	4,484,000	513,830,000	0.87%
Wisconsin Retirement System	Legislative	9	$26.3	7,691,000	879,293,000	0.87%
N.C. Teachers' & State Employees' Retirement System	Legislative	7	26.8	2,655,000	745,476,000	0.36%
Total			$429.5 billion	$268.5 million	$18.9 billion	----
Average			$28.6 billion	$17.9 million	$1.3 billion	1.42%
Board Oversight Average			$28.9 billion	----	----	1.76%
Legislative Oversight Average			$28.6 billion	----	----	1.33%

*Source: PENDAT, 1992.

concerns that appropriation of operating expenses could result in the diversion of retirement trust funds. Sunset staff agrees that funds held in trust should be preserved.

- **The State Constitution and the Internal Revenue Code authorize Legislative appropriation and oversight of operating expenses.**

  - The Texas Constitution specifies that the TRS Trustees are to manage the Retirement Fund, holding assets of the Retirement Fund in trust solely for member benefit. Appropriating operating expenses from general revenue, rather than from the Retirement Fund, preserves all assets for the benefit of members.

  - Allowing TRS to use retirement funds to supplement appropriations, if necessary, to carry out constitutional responsibilities, ensures the Trustees can meet their fiduciary duties.

  - To maintain its tax exempt status, the Internal Revenue Code mandates that a pension system must prevent any part of the retirement fund from being diverted for purposes other than for the exclusive benefit of the members. Appropriation of operating expenses clearly does not conflict with this mandate.

- **Legislative oversight of agency operating expenditures will strengthen the Fund by ensuring all members' money is used to improve the Fund and that the State's $1 billion annual contribution is properly managed.**

  - Legislative appropriations and oversight of TRS operating expenses will strengthen the Fund by ending the current practice of dipping into the Fund to pay for growing operating expenses.

  - Requiring TRS operating expenses to be subject to the appropriations process will more directly link agency spending to administrative performance.

  - Legislative oversight will also expand the review of TRS' budget beyond that currently exercised by TRS Trustees. Performance measures and efficiency standards of the state's strategic planning and performance budgeting system will be extended to TRS administration.

  - The Legislature has a duty to retirees, future retirees, and taxpayers to ensure that contributions to the Fund are

The State Constitution permits legislative appropriation and oversight of TRS operating expenses.

administered wisely and prudently for members' benefit.

Conclusion

The Teacher Retirement System receives $1 billion a year from taxpayers and approximately $900 million a year from TRS members as contributions to their retirement. In TRS' most recent Legislative Appropriations Request, it asks for $1.12 billion in fiscal year 1996 and $934 million in fiscal year 1997. Although the Board must prudently invest those funds, TRS Trustees have not adopted the strategic planning and performance budgeting system that have saved state operating expenses since 1991. TRS operating expenses have almost doubled over the past five years.

TRS' operating expenses have not been subject to the state's appropriations process in recent years. As a result of being outside the system of performance measures controlling the growth of other state agencies' administrative overhead, TRS operating expenses have grown faster than Fund membership. While other state agencies must justify the dollars they spend, TRS has spent an ever-growing amount of its members' money without standard state oversight.

Additionally, TRS is not subject to the usual administrative policies set by the Legislature for most other state agencies. The state's General Appropriations Act sets out these policies and standards to encourage greater agency accountability, effectiveness, and efficiency. These standards, which relate to sound business practices, include hiring practices, pay scales, travel regulations, office space utilization, guidelines for the use of legal counsel, purchase of information resources, and contracting procedures.

Recommendations

Changes in Statute

- **Make TRS subject to the appropriation process for operating expenses which would be appropriated separate of the state's contribution to the Retirement Fund.**
- **Make TRS subject to the General Appropriations Act, including provisions in Article V.**
- **Authorize TRS to use retirement funds to supplement appropriations for operating expenses only when necessary to meet Constitutional requirements.**
- **Require TRS to report to the Legislature and TRS members the amount of retirement funds used to supplement appropriated funds, how the funds were used, and why they were needed.**

These recommendations will increase oversight of the budget process and directly benefit TRS members by reducing administrative expenditures of their retirement dollars, while preserving the Trustees' ability to perform their fiduciary responsibilities. Funds to pay for operating expenses for TRS-Care should come from the Retired School Employees Group Insurance Fund to prevent any diversion of state contributions from the Retirement Fund. To promote operating efficiency, the agency should be authorized to transfer unused operating appropriations to the Retirement Fund at the end of each biennium.

By appropriating operating expenses, TRS will participate in the state's strategic planning and performance budgeting process and will operate under all relevant administrative policies set out in the General Appropriations Act.

Finally, if TRS Trustees determine that legislative appropriations are not sufficient to safely operate the retirement system, TRS may dip into member's money for additional operating expenses. However, the agency would have to report to the Legislature and TRS members how much has been used and why it was needed.

Fiscal Impact

This recommendation will have a positive impact on the Retirement Fund. Based on 1992 data, public pension systems with legislative oversight spent 24 percent less, on average, than systems without legislative oversight.

Fiduciary... An expression including both technical fiduciary relations and those informal relations which exist whenever one man trusts and relies upon another. It exists where there is special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to interests of one reposing the confidence. A relation subsisting between two persons in regard to a business, contract, or piece of property, or in regard to the general business or estate of one of them, of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faith. Out of such a relation, the law raises the rule that *neither party may exert influence or pressure upon the other,* take selfish advantage of his trust, or deal with the subject-matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of the utmost good faith and with the full knowledge and consent of that other, business shrewdness, hard bargaining, and astuteness to take advantage of the forgetfulness or negligence of another being totally prohibited as between persons standing in such a relation to each other. Examples of fiduciary relations are those existing between attorney and client, guardian and ward, principal and agent, executor and heir, trustee and cestui que trust, landlord and tenant, etc.

FROM: BLACK'S LAW DEFINITION, 5TH EDITION
(emphasis added)

Issue 6

Prohibit TRS from lobbying and improve the accuracy of information provided to members.

Background

State agencies are required to administer laws passed by the Legislature. The Legislature has added provisions to the General Appropriations Act and Government Code prohibiting state agencies from using state funds to influence the passage or defeat of legislation.

The Constitution, in the separation of powers clause, provides the basis for prohibiting agencies from lobbying. The separation of powers clause gives the Legislature the authority to make policy and gives state agencies the duty to carry out that policy.

With regard to pension policy, the Legislature, and not the Trustees or staff of state pension funds, is constitutionally charged with setting benefit levels for retirement programs and maintaining the financial health of state pension funds. The constitutional and statutory duty of the TRS Trustees and staff is to administer the Retirement System and invest retirement funds.

In addition to the state's broad lobbying prohibitions, the 72nd Legislature added a rider to the General Appropriations Act specifically prohibiting TRS staff and Trustees from lobbying. The rider prohibits mailings or telephone solicitations encouraging system members and others to lobby the Legislature or the general public on behalf of TRS. The text of the rider is shown in the box, *TRS Appropriations Rider.*

However, no enforceable penalty exists for violations of this rider.

The Legislature is required to set pension policy and ensure an actuarially sound system, while the Trustees, as policymakers for a state agency, are required to carry out legislative policy and invest state and member contributions for the benefit of the members. As a state agency, TRS Trustees and

The Legislature, and not TRS Trustees or staff, is responsible for benefit increases.

TRS Appropriations Rider

(Page III-30, Text of Senate Bill 5, 73rd Legislative Session)

Lobbying Prohibition. None of the Funds hereby appropriated, or dedicated by constitutional provision, may be expended for lobbying on behalf of the Teacher Retirement System or the constituency which it serves. Such prohibitions shall include, but is not limited to, correspondence or mailings and telephone solicitation encouraging members and other interested individuals to lobby the Legislature or general public on its behalf.

staff have an obligation to provide unbiased, credible information to the Legislature. To fulfill its role, the Legislature must be able to fully trust information provided by the agency. The most basic concept of credibility is trust.

FINDINGS

▼ **Advocacy by TRS Trustees or staff for benefit changes or increased funding levels abuses the nature of the trust relationship between the Legislature and the Retirement Fund and demonstrates a conflict of interest.**

◗ The Constitution sets the duties of the Trustees and staff — to properly invest the fund and administer benefits. Neither the Constitution nor statute direct TRS Trustees or staff to advocate benefit increases or legislative changes. Because six of the nine Trustees are members or retirees of the system, they have a vested interest in benefit increases. Trustees should acknowledge this interest and refrain from advocating for benefit increases.

◗ The following examples show instances in which TRS Trustees and staff have exceeded their responsibility to provide information to the Legislature by advocating legislative change:

- In June 1994, the Trustees adopted "legislative principles" designed to influence the Legislature for the 74th Legislative Session. These principles, along with comments from Sunset staff, are listed in the chart, *Legislative Principles Adopted by TRS Trustees*.
- *TRS News*, the TRS member newsletter, contains numerous examples in past years of Trustee proposals or official positions designed to influence the Legislature by influencing TRS members. Some of these official positions are described in the chart, *Summary of Attempted Legislative Influence in TRS News*. Publication of *TRS News* is paid for by interest earned on state and member contributions to the Retirement Fund and membership fees.
- In pre-retirement counseling sessions for TRS members held throughout the state, TRS staff discussed a "great opportunity" for benefit increases and a proposal to increase the retirement

Legislative Principles Adopted by TRS Trustees

(Annotated and Commented Upon by Sunset Staff)

1. Legislation affecting TRS should assure the preservation of the financial and actuarial integrity of the trust fund.

   Sunset Comment - The State Constitution requires that the Legislature finance all benefits based upon sound actuarial principles. This principle is merely a restatement of what is already required of the Legislature.

2. Actuarial gains by TRS should be used solely for the benefit of members, including regular annuity increases and improvements to the plan of benefits.

   Sunset Comment - Since actuarial gains can never be removed from the Retirement Fund, such gains are safe. However, any addition or improvement to benefits is solely the prerogative of the Legislature.

3. Consistent with the purposes of a retirement program, plan improvements should be designed generally to benefit the membership as a whole.

   Sunset Comment - This principle is in fact federal law. Again, however, any additions or improvements to benefits can only be approved by the Legislature.

4. Post-retirement benefit increases should be targeted to erase by 1999 the inflationary losses that have been incurred by retirees.

   Sunset Comment - This is in fact a commitment made by the Legislature during the 73rd Session. At that time, the first of what is expected to be four biennial ad hoc increases was given to reduce the effects of inflation on TRS retirees.

5. The most effective long-term solution to inflationary pressures on retirement benefits is an automatic indexed benefit with proper actuarial safeguards.

   Sunset Comment - While this may be true, the Legislature is constitutionally charged with establishing benefits, which includes any system to provide automatic benefit increases.

6. To promote inter-generational equity among members and taxpayers, state and member contributions should be established at a fixed percentage of pay, rather than allowed to fluctuate from biennium to biennium.

   Sunset Comment - This principle would require a constitutional amendment since the State Constitution clearly establishes a range for state and member contributions. In addition, the State Constitution charges the Legislature with establishing benefit programs for retirement and providing adequate funding for those programs.

7. Compensation and benefits (including health insurance) of Texas public education employees should be fully comparable to those provided to state employees.

   Sunset Comment - It is the responsibility of the Legislature to determine policies regarding the compensation package offered state employees, just as it the responsibility of the over 1,000 public school districts in the state to determine polices regarding the compensation packages for their employees. TRS has no jurisdiction over either policy area.

8. The responsibility of the TRS Trustees to make decisions, provide advice, and take action based solely upon the best interest of its membership should be preserved and strengthened.

   Sunset Comment - Neither the State Constitution nor the TRS statute require such a role for Trustees as mentioned in this principle. Rather, the Trustees are charged with investing the Fund's assets and administering annuity payments.

When TRS Trustees and staff advocate a specific policy or position on a legislative issue, it is difficult to determine whether the information provided is truly objective or designed to steer the Legislature toward an advocated position.

formula multiplier from 2.0 to 2.2. TRS staff then encouraged TRS members to contact their Legislators. The Appropriations Act prohibits TRS staff from encouraging individuals to lobby the Legislature.

This proposal, which affects some retirees differently from others, was developed by a constituent group, but has been actively publicized and advocated by TRS Trustees and staff.

- In a speech given to Killeen area active and retired teachers on October 24, 1994, the TRS executive director described one of his duties as advocating regular annuity and benefit increases for retirees, and himself as their 'champion'. Neither the Constitution nor statute authorize TRS staff to advocate benefit increases.

Summary of Attempted Legislative Influence in *TRS News*

- The July 1994, *TRS News*, published the list of "legislative principles" adopted by TRS Trustees. These principles outline and advocate proposed pension policies for the 74th Legislative Session. Similar legislative principles were adopted by the Board in December 1992.
- Also in the July 1994 newsletter, active and retired members were encouraged to contact either "their professional organizations or TRS with their ideas and opinions" on the possibilities presented by the reduction in TRS' funding period.
- The January 1994 *TRS News* solicited input from members and retirees in an effort to prepare legislative proposals for the 74th Legislative Session.
- In the March 1993 *TRS News*, the TRS Board opposed a rider to the General Appropriations Act placing TRS under the appropriations process for its operational budget.
- In July 1991, the agency published a special issue of *TRS News*. This edition informed members of the Trustees' opposition to legislation based on the Texas Performance Review's report, *Breaking the Mold*. The use of pension fund assets led to a newspaper article that stated TRS spent $123,664 of the Retirement Fund to publish the newsletter.

- When TRS Trustees and staff advocate a specific policy or position on a legislative issue, it is difficult to determine whether the information provided is truly objective or designed to steer the Legislature toward an advocated position.

▼ **Many groups are available to advocate changes to retirement benefits without the advocacy efforts of TRS Trustees and staff.**

- Senator Teel Bivins, a member of the Senate Finance Committee, stated in a letter to the Chair of the TRS Trustees that, "TRS is a state agency and should behave as one. A very capable group of Texans organized in the Texas Retired Teachers Association effectively and legally lobbies on behalf of TRS. The distinction between TRS and TRTA has been blurred on many occasions."

- There are numerous organizations representing educators in Texas including: the Texas Classroom Teachers Association, the Association of Texas Professional Educators, the Texas State Teachers Association, the Texas Federation of Teachers, and many others. Such organizations are capable of advocating policies for their members and play an important and legitimate role in the debate over benefits.

TRS, a state agency, should participate in this debate as an objective provider of credible information, not as an advocate.

- **Legislative concern with lobbying by the TRS Trustees and staff resulted in an Appropriations Act rider prohibiting attempts to influence legislation.**

  - The current TRS appropriation which sets legislative contributions to the Retirement Fund, includes a specific prohibition against lobbying by TRS.

  The rider directly prohibits TRS from using state or member contributions to contact TRS members for the purpose of influencing legislation.

- **TRS has also attempted to exert influence upon the Legislature and TRS members by providing inaccurate information.**

  - A fiduciary relationship requires accurate information between the parties and prohibits one party from attempting to influence the other. However, TRS Trustees and staff have attempted to influence their members through inaccuracies and by omitting key information.

  - In a speech given to Killeen area active and retired teachers on October 24, 1994, the TRS executive director spoke of his duty to guard against raids on the pension fund. This type of language raises concern among TRS members that the Legislature is considering taking money from the Retirement Fund to use in other areas. Such raids are prohibited by the Texas Constitution and have never been contemplated or attempted. In fact, every Legislature has increased TRS retiree benefits since 1975.

  - While the Trustees and staff have provided information to TRS members about increasing the retirement formula multiplier from 2.0 to 2.2, the agency has not informed its membership that the proposal may not be affordable and is based on

TRS, a state agency, should provide objective information in the benefits debate, not act as an advocate.

actuarial assumptions that may change. TRS staff has indicated to the Legislative Budget Board staff that the multiplier increase may or may not be affordable.

In addition, a letter to the legislative leadership from the Chair of the TRS Board of Trustees states that determination of an appropriate funding level "must be delayed until the results of new studies are received."

- In addition, members have not been told that this proposal could limit future increases to retirees to offset inflation, thus conflicting with the TRS Trustees 'principles' to benefit all TRS members (principle 3, page 47). Due to its cost, the proposal would also absorb funds that might otherwise be used for indexed benefit increases, (principle 5, page 47).

TRS Bias in Legislative Communications

Piece of Legislation	Committee Substitute House Bill 7	Committee Substitute Senate Bill 216
Purpose of the Bill	Ad hoc retiree increase, automatic cost of living adjustment (COLA), and other changes.	Additional service credit for vocational education teachers.
TRS position on the Bill	Strongly in favor.	Unofficially opposed.
Effect on Amoritization Period	Increase of 5.8 years for ad hoc increase and other changes; impact not projected for automatic COLA because of uncertainties about level of future actuarial gains.	Increase of 0.1 year, without projection of future trend in the number of vocational education teachers.
Discussion of Actuarial Impact	In the actuarial impact statement submitted by TRS, the actuary stated that this bill would not adversely affect the soundness of the pension fund, without quantifying or projecting the effect of the COLA. In its review of TRS' actuarial analysis, the Pension Review Board's (PRB's) consulting actuary commented that the analysis did, " not provide complete disclosure of the potential impact of the automatic COLA."	In the actuarial impact statement submitted by TRS, the actuary concluded that the bill "would weaken the actuarial funding status of the system." Although the actuarial impact was minimal, he warned, without qualifying, that future hiring of vocational education teachers would increase the impact of the bill.

Source: State Auditor's Office Report on TRS, December, 1992.

◗ In a 1992 management audit of TRS by the State Auditor's Office, a finding shows how TRS structured its communications to members of the 72nd Legislature in order to favor the System's views and interests. The chart, *TRS Bias in Legislative Communications* illustrates this. The agency appears to have provided favorable information on a costly change and unfavorable information on a change that would have had a minimal impact on the Fund.

◗ In its December 1993 newsletter, TRS claims that its share for TRS retirees eligible to transfer to ERS in an early retirement incentive program would cost $9.1 million. When contacted by Sunset staff, TRS staff indicated that the $9.1 million figure could be much less. However, no such point has been communicated to the membership.

◗ TRS-related interest groups such as the Texas Classroom Teachers Association (TCTA) have expressed to Sunset staff their skepticism over the accuracy of TRS-provided information. In response to a survey taken by Sunset staff, the TCTA stated that the sudden change in TRS' funding period from 25.1 to 5.6 years made them, "...somewhat skeptical of the responses we receive to our requests for information (no matter how promptly they are given)."

▼ **TRS has also failed to correct inaccurate rumors and information.**

◗ TRS spends $910,000 yearly to conduct regional counseling sessions throughout the state. These sessions are an excellent opportunity to address any erroneous information members may encounter regarding their retirement system.

TRS spends $910,000 for statewide counseling sessions with its members.

During the course of the Sunset review, numerous rumors spread throughout the education community. TRS staff made no apparent effort to correct inaccuracies, despite the opportunity at each counseling session to do so.

A summary of the rumors Sunset staff encountered and that were reflected in correspondence to lawmakers, as well as the factual situation relating to them, is detailed in Appendix 2.

▼ **Despite the provisions in the General Appropriations Act and the Government Code that prohibit lobbying, no enforceable penalties exist**

TRS Trustees and staff have continued to attempt to influence the Legislature and TRS members despite statutory prohibitions.

for violations of these provisions.

- None of the above mentioned provisions contains a mechanism for penalizing state employees or Trustees who violate the prohibition on lobbying. The only sanction available through the Appropriations Act is to withhold the State's contribution to the Retirement Fund. However, such an action would penalize the TRS members instead of the Trustees and hired staff members responsible for committing these prohibited acts.

▼ **Requiring TRS to report Pension Review Board (PRB) analyses of the effects of proposed benefit changes will help ensure TRS members receive accurate information.**

- The PRB has the responsibility and actuarial expertise to determine the effects of proposed pension system legislation. Members of the System would be better served by receiving unbiased information from the PRB.

CONCLUSION

The constitutional duty of the Trustees and their hired staff is to administer the system and invest the Retirement Fund. The TRS Trustees and staff continue to attempt to influence both TRS members and the Legislature despite prohibitions in statute and the Appropriations Act and against objections of Legislators that these activities are against the law. Such attempts to influence legislation have occurred by direct lobbying and providing inaccurate information to both TRS members and the Legislature. Such information can best be characterized as neither objective nor credible.

Not only does such activity violate state policy, it abuses the fiduciary relationship between TRS and its members.

While good public policy is served by member representation on the Board of Trustees, Trustees with a vested interest in benefit increases should leave advocacy of these interests to constituent groups and strive to be objective in accordance with their fiduciary responsibilities.

TRS Trustees and staff have a responsibility to the Legislature to provide timely and accurate information. In addition, the Trustees have the responsibility to acknowledge their vested self-interest in obtaining benefit increases. The Legislature is responsible for appropriating money to the system to keep it sound, setting benefit levels, providing benefit increases, and defining the range of investments. Without objective information, the Legislature has a more difficult time ensuring the soundness of the Fund and maximizing the performance of the system for the benefit of the members.

TRS Trustees and staff counter charges of lobbying with the argument that everyone is entitled to free speech. While TRS Trustees and staff are certainly entitled to free speech, saying that the Legislature is going to raid the fund is analogous to yelling fire in a crowded theater. Since such activity has continued over time despite prohibitions established in the General Appropriations Act and the Government Code, a mechanism to ensure that the Legislature and the TRS members receive accurate information needs to be enacted.

Recommendations

Changes in Statute

- **Prohibit TRS Trustees and staff from using Fund resources, state contributions, or member contributions for advocacy to influence legislative action.**
- **As part of the appropriations process, require TRS to submit a report to the Legislative Budget Board, Senate Finance Committee and the House Appropriations Committee detailing uses of appropriated funds, member funds, or other resources used for governmental relations, member counseling, or official publication of positions.**
- **Require TRS to obtain balanced information from the Pension Review Board on the effects of proposed legislation on members' retirement benefits and report such information to its members.**

TRS Trustees and staff must discontinue their advocacy of benefit and pension plan changes. This recommendation will prohibit TRS from carrying out activities designed to influence legislative actions.

Requiring specific spending reports on TRS Trustees and staff communications will increase Trustee and legislative awareness of possible lobbying activities. The Legislative Budget Board, Senate Finance Committee and House Appropriations Committee are the bodies overseeing state spending and would be the appropriate recipients of this information. Finally, requiring TRS to obtain independent information on the effects of proposed pension legislation from the Pension Review Board and relaying information directly to TRS members will help to ensure that TRS members receive objective information on proposed legislation. The Pension Review Board is required to calculate the actuarial impact of pension legislation affecting state pension funds.

Management Action

- **Require the State Auditor's Office to monitor and report lobbying activity conducted by TRS Trustees or staff to the Legislative Budget Board.**

The State Auditor's Office (SAO) already monitors TRS activities as part of its annual audit plan. Requiring the SAO to report lobbying activities to the Legislative Budget Board provides a mechanism for enforcing this prohibition.

FISCAL IMPACT

No fiscal impact will result from this recommendation. The State Auditor's Office includes TRS in its audit plan and no additional expenses will result from the monitoring role. The Pension Review Board already determines the effects of proposed legislation for members of the Legislature and could readily provide TRS with such information. Such activity will require no additional resources. Distribution of the Pension Review Board's information to TRS members should be paid for by TRS.

Issue 7

Increase funds for retiree benefits by making economical use of TRS headquarters facilities.

Background

House Bill 2626, passed during the 73rd Legislative Session, requires the General Services Commission (GSC) to study the use of office space by state agencies. The study looks at how much space is needed for various state agency uses, and how to efficiently allocate space to the agencies.

The legislation prohibits GSC from allocating more than 153 square feet of usable space per employee to most state agencies although GSC can exclude certain types of space such as libraries, storage space, and training rooms from the calculation.

Although GSC's authority to allocate space is limited to those buildings it controls, the state standard is a useful test of efficient space use.

To apply this standard to most state agencies, the Legislature included a rider in the General Appropriations Act directing most executive branch and human service agencies to make every effort to meet the 153 square feet of space per employee goal. This rider requires each agency to report its progress toward meeting this standard in its annual financial report.

The Teacher Retirement System (TRS) is not subject to the General Appropriations Act rider because it does not receive appropriations for operating expenses.

Instead, the agency draws its annual operating budget from membership fees and interest income. In recent years, TRS Trustees have not trimmed the agency's budget. In fact, the agency's total operating expenses grew about 83 percent in five years from 1989 to 1994 while other agencies operating expenses have increased about 50 percent.

TRS owns and occupies two buildings in downtown Austin. The west building was built in 1973 and renovated when the east building was built in 1990. The chart, *Total Gross and Assignable Square Feet Space*, shows the square footage in each of the two buildings. The agency spends about $1.2 million each year on the operation and maintenance of these two buildings.

The agency spends about $1.2 million each year on the operation and maintenance of its two buildings.

Useable space in the TRS buildings includes exercise rooms, a greenhouse, and break and coffee rooms.

In examining ways to reduce expenditures from the Retirement Fund, Sunset staff examined whether savings could be achieved by applying the state's space utilization standard to the agency.

FINDINGS

▼ **TRS significantly exceeds the state space utilization standard that applies to most other agencies.**

- Because GSC does not control the TRS buildings, the standard does not legally apply to TRS. However, no reason was identified that should prevent TRS from striving to meet standards that apply to most other state agencies.

Total Gross and Assignable Square Feet Space

Building	Floor	Gross Square Feet	Assignable Square Feet
West	1	22,923	11,533
	2	16,736	10,031
	3	16,832	11,593
	4	16,848	13,668
	5	7,045	0
	Total	80,384	46,825
East	1	28,928	19,110
	2	28,800	14,952
	3	20,288	15,132
	4	20,288	13,178
	5	20,304	14,683
	6	10,368	3,104
	Total	137,592	80,159
Grand Total		217,976	126,984

- At the request of Sunset staff, GSC conducted an analysis of the agency's use of office space. The analysis indicated that TRS occupies about 320 square feet of space per employee, or more than twice the state standard. The excess space occupied by TRS, 167 square feet per employee, totals about 66,200 square feet. This is greater than the total space available in the agency's west building.

The GSC analysis included only usable square footage, excluding about 82,600 square feet of space. Usable space, by definition, does not count public hallways, restrooms, elevators, stairwells, safety and mechanical space, interior atriums or courts for public use, and fire towers. In addition, GSC also excluded about 16,000 square feet of usable space that is currently allocated to a training room, library, computer room, storage room, dining facilities and vaults.

GSC's analysis was conducted on the remaining usable space that could be allocated to agency employees and included office space, exercise rooms, a greenhouse, board room, mail room, conference rooms, copy rooms, libraries, and break and coffee rooms.

- **The high ratio of space to employees is due in part to large areas that are not used as employee work space.**
  - More than 1,900 square feet are used for exercise and weight rooms.
  - More than 7,300 square feet are used for conference rooms and libraries in addition to the one library containing 848 square feet that was excluded from the analysis.
  - More than 1,900 square feet are used for coffee and break rooms, not counting the 7,900 square feet allocated to the building's cafeteria.
  - The mail room occupies more than 4,300 square feet. The mail room is a large underutilized space considering that TRS contracts out for the processing of more than 76 percent of its outgoing mail.
- **Another reason that the ratio of space to employees is high is due to the poor utilization of agency office space.**
  - The agency does not use about 2,000 square feet of high quality office space on the second floor of the east building.
  - Meanwhile in another section of the building, 22 employees in benefit processing work in a space of about 2,500 square feet, or about 114 square feet per employee, while 15 employees in the legal area work in 4,800 square feet, or about 322 square feet per employee.
- **Other state agencies occupy less space per employee than TRS.**
  - At least 70 agencies occupy less space per employee than TRS. This figure includes large agencies such as the General Services Commission, General Land Office, Department of Public Safety, Texas Workers' Compensation Commission, and Texas Department of Transportation. These large agencies occupy 175 square feet or less per employee.
- **Although the space was planned and built by a previous administration, the current administration could provide additional revenue for the Retirement Fund by complying with the state's 153 square feet standard and leasing the excess space.**
  - The agency has a surplus of about 66,200 square feet of prime downtown office space.

TRS occupies 320 square feet per employee, more than twice the state standard.

If TRS complied with state standards, it could lease one of its buildings and produce $860,000 per year to benefit retirees.

- If the 66,200 square feet of usable space was leased at the current Austin market rate of $13 per square foot rate, TRS could generate about $860,000 in additional revenue annually for the benefit of its members' Retirement Fund.

- The agency has adequate unused parking spaces to support tenants in its buildings. The analysis indicated that at least 100 parking spaces remain after employee and visitor needs are met.

▼ **The agency is already in the space leasing business.**

- The agency already leases about 4,200 square feet of space to TRS-Care, a separate health insurance program for TRS retirees, at a rate of $10 per square foot per year. This lease generates about $42,000 annually.

- In addition to leasing space to TRS-Care, the agency manages property it holds for investment purposes. The agency owns and contracts for the management of 40 commercial properties nationwide including office buildings, hotels, shopping centers, and apartment buildings.

- Other state agencies currently lease unused space to separate entities. Currently, this leased space totals more than 39,000 square feet. The chart, *Description of Leased Space in State-Owned Buildings*, describes the location, tenant and revenue associated with these leases.

Description of Leased Space in State-Owned Buildings

Location of Leased Space	Tenants	Square Footage Leased	Lease Revenue/Year
Clements Building	Mary's Hair Salon	888	$10,656
Winters Complex	SATO Travel	268	$4,462
Winters Complex	Greater Federal Credit Union	573	$5,157
Treasury Building	Guaranty Federal	125	$18,000
LBJ Building	U.S. Post Office	4,839	$4,800
Child Care Facility Buildings 1 and 2	Creative World Child Care Center	12,044	$1
University of Texas System Colorado Building	Multiple Tenants including MCI, attorneys and University Federal Credit Union	21,039	$314,640
TOTAL		39,776	$357,716

▼ **Development and implementation of space allocation plans can help to achieve a square footage ratio of 153 square feet per employee.**

- The General Services Commission requires each state agency subject to the space standard to develop and implement a space allocation plan. This plan describes how and when the agency will achieve the 153 square foot ratio.

- Some standard agency actions to improve space utilization include using modular furniture, co-locating with other agencies, remodeling, and sharing conference rooms and other "common" space with other agencies.

Conclusion

The Retirement Fund owns and the agency occupies two prime office buildings in downtown Austin. These buildings are assets of the Retirement Fund and the Trustees have the fiduciary duty to maximize their use for the benefit of the members. The agency is not subject to the state's space utilization standard and it uses more than twice the number of square feet per employee as the standard. A large amount of space is allocated to exercise rooms, a greenhouse, conference rooms, libraries and break rooms.

Many other agencies use less space per employee than TRS and a number of agencies of similar size have a space ratio closer to the standard.

Recommendations

Changes in Statute

- **Require the Teacher Retirement System to comply with the provisions related to space usage in the General Appropriations Act and in the state purchasing statute.**
- **Require TRS to develop a space allocation plan to be submitted to the General Services Commission for approval no later than March 1, 1996 and to implement the plan no later than September 1, 1996.**
- **Require TRS to lease all significant unused space in order to increase the return on System real estate to the Retirement Fund.**

This change would require the Teacher Retirement System to meet the state's space standards and provide additional revenue for the benefit of its members. The agency would be required to comply with the space allocation standard and reporting requirements in the General Appropriations Act as well as the standards and reporting requirements of the General Services Commission.

The agency could benefit the Retirement Fund and its members through increased revenues from leasing its space in excess of the state's 153 square feet standard. The agency owns and manages property nationwide and could use that same expertise to manage its headquarters as an asset to increase the revenues to the Retirement Fund.

FISCAL IMPACT

This recommendation would result in additional revenues to the Retirement Fund. If all identified underutilized space could be leased, TRS could earn up to $1.72 million each biennium. Although one-time costs for moving and remodeling may be necessary, these costs would be recovered from lease revenues. Agency plans do not contemplate future staff growth.

Issue 8

Require TRS to increase the use of businesses owned by women and minorities.

Background

The state has made the use of historically underutilized businesses (HUBs)—businesses owned by women and minorities—a priority by setting goals for their use in the General Appropriations Act and the State Purchasing and General Services Act. The Appropriations Act requires agencies to make a good faith effort to purchase no less than 20 percent of goods and services from HUBs, and the State Purchasing and General Services Act requires agencies to make a good faith effort to purchase no less than 30 percent of goods and services from HUBs.

Due to the state's changing demographics and growing number of women- and minority-owned businesses, the Legislature established a program for HUBs to ensure that businesses owned by women and minorities have an opportunity to do business with the state. The Legislature recognized that if businesses owned by women and minorities are not provided with the opportunity to participate in contracts offered by state government, the state will find it difficult to provide needed state services and overall business activity in Texas will suffer. The primary purpose of this program is to let women- and minority-owned businesses know how to do business with the state.

The state has made the use of HUBs a priority.

The TRS is subject to the HUB provisions and goals in the State Purchasing and General Services Act, but is not subject to HUB requirements in the General Appropriations Act.

The General Services Commission (GSC) has developed guidelines and policies for the use of HUBs. These guidelines and policies include:

- using a HUB vendor whenever possible for purchases less than $1,000;
- obtaining informal bids (usually by phone) from at least one woman-owned HUB and one minority-owned HUB for each purchase from $1,000 to $5,000; and
- obtaining formal bids from at least one woman-owned HUB and one minority-owned HUB for each purchase more than $5,000.

To increase the use of women and minority-owned businesses, GSC conducts up to 11 Economic Opportunity Forums each year. These forums provide HUBs with the chance to learn about current and future opportunities to do business with state agencies and acquaint these businesses with state purchasing requirements and provisions.

A review of TRS policies and programs was conducted to determine if the agency has met goals established by the Legislature for the use of HUBs, and if the agency has developed policies to increase its use of HUBs.

FINDINGS

▼ **TRS has not met state goals for the use of HUBs and uses HUBs less than other agencies.**

- TRS has not achieved the 30 percent goal set in the State Purchasing and General Services Act and has consistently been below the statewide average use of HUBs by all state agencies. In fiscal year 1994, TRS' use of HUBs was 6.39 percent, while the statewide agency average was 11.88 percent. The chart, *TRS and Statewide HUB Purchases (1991-1994)*, compares the percentage of TRS purchases made from HUBs to the statewide average.

- According to the Legislative Budget Board (LBB), TRS spent almost $3 million on contracts for financial services, excluding brokerage fees, in fiscal year 1994. TRS did not use HUBs for any of these contracts.

- In fiscal year 1994, TRS contracted with 76 brokerage firms for security trading, with only one of those brokerage firms being minority owned.

TRS and Statewide HUB Purchases
1991 - 1994

Year	Total Purchases	HUB Purchases	HUB Percent	Statewide HUB Average	GS Act Goal
CY91	$1,045,692	$4,918	0.47%	1.48%	10%
CY92	$5,598,967	$70,197	1.25%	2.17%	10%
CY93	$6,693,374	$344,792	5.15%	8.33%	10%
FY94*	$6,868,306	$438,543	6.39%	11.88%	30%

*Texas Department of Commerce reported HUB information by calendar year from 1990 - 1992. The General Services Commission took over this responsibility and began to report the information by fiscal year 1994.

▼ **Other agencies that do significant levels of business with HUBs aggressively pursue GSC policies, and develop their own additional policies to increase the use of HUBs.**

◗ According to the General Services Commission, the most successful HUB programs consistently take an aggressive approach in identifying and using HUBs within the policies and guidelines established by the State Purchasing and General Services Act.

◗ According to agencies with successful HUB programs—including the Department of Information Resources, the Department of Protective and Regulatory Services, and the Office of the Comptroller of Public Accounts—developing a good HUB program entails:

- a written plan to increase the use of HUBs that includes a mission statement, goals, and strategies to reach those goals;
- an outreach program to inform HUBs of contracting opportunities and proposal standards used by the agency;
- pro-active identification of HUBs through workshops, seminars and Economic Opportunity Forums;
- consistent communication with HUBs that provide quality goods and services; and
- a process to ensure that HUBs are certified with the General Services Commission.

▼ **Although the agency is subject to the State Purchasing and General Services Act, it does not comply with all of the Act's HUB provisions.**

◗ Although the agency's legal counsel indicated that the State Purchasing and General Services Act applies to TRS, the purchasing staff of the agency indicated their understanding that the agency is not subject to the HUB provisions in the State Purchasing and General Services Act. However, the purchasing staff said that they are voluntarily trying to comply as long as compliance did not violate the agency's fiduciary responsibilities.

◗ While the agency has included a goal in its strategic plan to increase the use of HUBs, it has not established a plan for increasing the use of HUBs as required by the State Purchasing and General Services Act.

◗ The agency does not produce the required internal

While the state goal for the use of HUBs is 30 percent, the agency used 6.4 percent.

monthly report showing the use of HUBs by each operating division. This report is intended to show the agency areas where additional steps need to be taken to meet state goals.

- TRS has not established an outreach program to inform HUBs of current and future TRS bid and contract opportunities, or informed HUBs of agency purchase and contract standards.

Conclusion

While the state has made increasing the use of HUBs for the purchase of goods and services a priority, the agency has not matched the performance of many other agencies. Although use of HUBs has increased, the agency's percentage use of HUBs has been consistently lower than the statewide average since 1991. This is due, in part, to other state agencies having more aggressive strategies to identify and use HUBs for purchases, and because the agency has failed to meet statutory requirements for HUB programs.

Recommendations

Change in Statute

- **Add language to the TRS statute to specify that the agency must follow provisions in the State Purchasing and General Services Act, including HUB requirements.**

This recommendation would clarify that TRS is required to follow provisions in the State Purchasing and General Services Act relating to the use of HUBs.

Management Action

- **Increase efforts to purchase goods and services from HUBs by:**
  - **aggressively following State Purchasing and General Services Act provisions;**
  - **developing an outreach program to provide contract and bid information to HUBs, and education and training on TRS proposal standards and procedures; and**
  - **establishing a written plan to increase the use of HUBs that includes a mission statement, goals, and strategies to meet those goals.**

Without an aggressive program to pursue contracts with HUBs, the agency has not been able to significantly increase its use of HUBs. The recommended approach would encourage the agency to establish an aggressive program similar to other state agencies.

Fiscal Impact

This recommendation would not result in a fiscal impact to the Retirement Fund or the state.

Issue 9

Schedule TRS for the standard Sunset review in 12 years if TRS operating expenses are subject to the appropriations process.

Background

The Sunset review of the Texas Teacher Retirement System and the resulting recommendations in this report are intended to deal with problems including rising operating costs, lack of independent oversight or timely information on investment performance, and failure to abide by prohibitions against lobbying.

Based on the problems encountered in this review, stronger legislative oversight of TRS is necessary and appropriate. Greater oversight would allow the Legislature to more closely monitor the performance and operation of the agency to detect potential problems early enough to make corrections, and ensure the ongoing health and viability of the Teacher Retirement Fund.

Although TRS receives a constitutionally mandated appropriation to help pay benefits, it is not subject to the strategic planning or performance budgeting requirements of the appropriations process, or standard efficiency provisions of Article V of the General Appropriations Act. In addition, the Sunset provision in the TRS statute expires in September, 1995 which removes TRS from future Sunset review.

TRS is not subject to the oversight provisions in the appropriations process and after September 1995 will not be subject to the Sunset Act.

Recommendations

Change in Statute

- **If TRS is made subject to the appropriation process, require TRS to remain under the Sunset process and review TRS after the standard 12-year period in 2007.**

If TRS operating expenses are made subject to the appropriations process, TRS should remain subject to the Sunset Act and undergo another Sunset review after the standard 12-year period has elapsed. This would require TRS to undergo another Sunset review in 2007.

If TRS operating expenses are not made subject to oversight through the appropriations process, TRS should remain subject to the Sunset process during the upcoming biennium. Such oversight would require TRS to submit another Self-Evaluation

Report to the Sunset Commission and require the agency to undergo full Sunset Review. This review would provide alternate means by which the Legislature could oversee the efficiency and effectiveness of TRS operations. Sunset recommendations would be available for legislative consideration in 1997.

Management Action

- **Require the State Auditor's Office to identify issues related to the operational effectiveness and efficiency of TRS, as well as compliance with its statute, for inclusion in TRS' annual internal audit plan.**

This action will require input from the State Auditor's Office into the formulation of the TRS internal audit plan. Once the SAO-enhanced internal audit plan has been completed, the TRS internal auditor will submit the findings of that plan to the Legislative Budget Board, the State Auditor's Office, the Sunset Commission, and the Pension Review Board.

FISCAL IMPACT

The Sunset Commission staff could evaluate the agency without additional resources. No additional resources will be required by SAO to provide input into TRS' internal audit plan.

Teacher Retirement System of Texas		
Recommendations		**Across-the-Board Provisions**
		A. GENERAL
Apply/Modify	1.	Require at least one-third public membership on state agency policymaking bodies.
Already in Statute	2.	Require specific provisions relating to conflicts of interest.
Update	3.	Prohibit persons required to register as a lobbyist from acting as general counsel to the agency or policymaking body or serving as a member of the policymaking body.
Already in Statute	4.	Require that appointment to the policymaking body be made without regard to the appointee's race, color, disability, sex, religion, age, or national origin.
Update	5.	Specify grounds for removal of a member of the policymaking body.
Apply	6.	Require agencies to prepare an annual financial report that meets the reporting requirements in the appropriations act.
Update	7.	Require the agency to establish career ladders.
Update	8.	Require a system of merit pay based on documented employee performance.
Already in Statute	9.	Provide for notification and information to the public concerning agency activities.
Do Not Apply	10.	Require that all agency funds be placed in the treasury to ensure legislative review of agency expenditures through the appropriations process.
Apply	11.	Require information to be maintained on complaints.
Update	12.	Require that all parties to written complaints be periodically informed in writing as to the status of the complaint.
Update	13.	Require development of an E.E.O. policy.
Update	14.	Require that information on standards of conduct be provided to members of policymaking bodies and agency employees.
Already in Statute	15.	Provide for public testimony at meetings of the policymaking body.
Update	16.	Require the agency's policymaking body to develop and implement policies that clearly separate the functions of the policymaking body and the agency staff.
Update	17.	Require development of an accessibility plan and compliance with state and federal accessibility laws.
Apply	18.	Provide for the Governor to designate the presiding officer of a state agency's policymaking body.
Apply	19.	Require the agency to comply with the state's open meetings law and administrative procedures law.
Apply	20.	Require training for members of policymaking bodies.

Teacher Retirement System of Texas (cont.)		
Recommendations		**Across-the-Board Provisions**
		B. LICENSING
Not Applicable	1.	Require standard time frames for licensees who are delinquent in renewal of licenses.
Not Applicable	2.	Provide for notice to a person taking an examination of the results of the examination within a reasonable time of the testing date.
Not Applicable	3.	Provide an analysis, on request, to individuals failing the examination.
Not Applicable	4.	Authorize agencies to establish a procedure for licensing applicants who hold a license issued by another state.
Not Applicable	5.	Authorize agencies to issue provisional licenses to license applicants who hold a current license in another state.
Not Applicable	6.	Authorize the staggered renewal of licenses.
Not Applicable	7.	Authorize agencies to use a full range of penalties.
Not Applicable	8.	Specify disciplinary hearing requirements.
Not Applicable	9.	Revise restrictive rules or statutes to allow advertising and competitive bidding practices that are not deceptive or misleading.
Not Applicable	10.	Require the policymaking body to adopt a system of continuing education.

Background

Creation and Powers

A 1936 amendment to the Texas Constitution authorized a retirement system for teachers. The following year, the Legislature created the Teacher Retirement System of Texas (TRS) to provide retirement benefits for teachers and administrators of Texas public school districts and public institutions of higher education. In 1949, the Legislature expanded coverage to all employees of public education institutions including cafeteria workers, bus drivers, and other support workers.

The Constitution directs the Legislature to create a Board of Trustees responsible for administering the System and investing the Fund in a prudent manner.

The Constitution establishes the Teacher Retirement Fund as a trust for the benefit of the members that may not be diverted for any other purpose. While the Trustees are responsible for administering the System and making investments, the Legislature is ultimately responsible for setting taxpayer and member contribution rates to ensure that the Fund has enough money to pay all members' benefits now and in the future.

When it was created, in 1937, TRS served about 38,000 members. Today it serves more than 606,000 potential retirees making contributions (active members), 128,000 retirees, and more than 9,700 surviving beneficiaries.

In 1938, the Trustees managed a Fund of about $2.2 million. Over the years, state and member contributions, and the investment of those accumulated contributions, have amassed to more than $38 billion. The chart, *Ten Largest Public Pension Systems in the U.S.*, shows its ranking in comparison with other large pension funds. Based on the most

The Constitution establishes the Teacher Retirement Fund as a trust for the benefit of the members and may not be diverted for any other purpose.

Ten Largest Public Pension Systems in the United States - 1992

Rank	System	Market Value of Assets
1	California Public Employees' Retirement System	$74.2
2	New York State and Local Employees' Retirement System	$53.4
3	California State Teachers' Retirement System	$40.8
4	Teacher Retirement System of Texas	$33.1
5	Florida Retirement System	$28.6
6	Ohio State Teachers' Retirement System	$26.9
7	N.C. Teachers' and State Employees' Retirement System	$26.8
8	PERS of Ohio - State and Local Division	$26.6
9	Wisconsin Retirement System	$26.3
10	Pennsylvania Public School Employees' Retirement Plan	$21.4

Source: PENDAT - 1992

recent information from the Public Pension Coordinating Counsel's Pension Data Base (PENDAT), Texas teachers' retirement is the 4th largest public pension fund in the United States.

A short summary of major legislative changes to retirement benefits is shown in the box, *History of Legislative Benefit Changes.*

History of Legislative Benefit Changes 1971 to 1993

Year	Increase	Description of Increase
1993	5 to 15 percent	Increase depending on year of retirement prior to 9/1/91
1991	1 percent per year	Increase per year of service before 5/31/89; set new minimum payment of $150 per month
1989	4 to 16 percent	Increase depending on year of retirement; $100 per month maximum increase
1987	5 to 20 percent	Increase depending on year of retirement
1984	3 to 9.5 percent	Increase depending on year of retirement; excluding retirees with compensation of >$25,000
1981	2 to 21 percent	Increase depending on year of retirement, with certain retirees receiving an additional 7 percent
1981	5.1 percent	Only if retired prior to 5/31/79
1979	13 percent or 6 percent	13 percent for pre-1969 retirees; 6 percent for post-1969 retirees
1977	Formula increased	Increase for those retiring before 5/31/77
1975	5 to 18 percent	Increase depending on year of retirement, with higher minimum payments
1971	10 percent	Increase with higher minimum payments

Source: Pension Review Board

There are three basic components to the Teacher Retirement System (System): (1) the Board of Trustees who administers the System and manages investments; (2) the Teacher Retirement Fund; and (3) the administrative staff.

POLICYMAKING STRUCTURE

TRS is governed by a nine-member, part-time Board of Trustees. The Governor appoints seven Trustees, four of who are nominated by the Fund's constituent groups, and the State Board of Education appoints two Trustees.

Of the seven members appointed by the Governor:

- three members are direct appointees who may not be active TRS members or retirees, two of whom must have demonstrated financial expertise; and
- four members—two current public school employees, one retiree, and one current employee of a public institution of higher education—are nominated and elected by their peers. The Governor appoints the Trustees from among the three candidates receiving the most votes from their peer group.

All Trustees are subject to Senate confirmation. Trustees serve staggered six-year terms and annually select a chair and vice-chair. The structure of the Board of Trustees is more fully described in the chart, *Current TRS Membership and Appointment Qualifications.*

The Texas Constitution makes the Trustees responsible for two duties: administering the System and investing the assets of the Fund. As Trustees of the Retirement Fund, Board members are fiduciaries and are responsible for performing these duties based on the "prudent person rule". This rule requires the Trustees to look after and manage the assets of the Fund at least as well as they would manage their own money. Pension funds must be held exclusively for members.

Trustees also have a duty to the Legislature to provide accurate and timely information. The Legislature, which appropriates about $1 billion annually to the Fund, is ultimately responsible for making changes to the benefit package and setting taxpayer and member contribution rates necessary to maintain the health of the System.

Trustees appoint an executive director to run the day-to-day activities of the System and an actuary to project Fund needs.

The Fund provides benefits to retirees, members with permanent disabilities, and survivors, and a separate fund offers a health insurance program to retirees. Trustees select a medical board to review medical applications for disability retirement benefits, and a group insurance advisory committee to assist in the administration of the health insurance program for TRS retirees.

Trustees also approve the budget for the retirement and retiree health insurance programs, and adopt rules related to System membership, administration of the funds and business transactions.

Trustees hold monthly meetings and have organized into seven subcommittees for audit, budget, ethics, investments, nominations, policy, and real estate.

The Legislature is ultimately responsible for setting benefits and contribution rates necessary to maintain the health of the System.

Current TRS Membership and Appointment Qualifications

- Three members appointed directly by the Governor. Two of these members must have demonstrated financial expertise, have worked in private business or industry, and have broad investment experience, preferably in dealing with pension funds.

  Frank W. (Bo) Camp, Kilgore (Retired Businessman)
  Ronald Steinhart, Dallas (Businessman)
  Dr. Kneeland Youngblood, Dallas (Physician)

- Two members appointed by the Governor from among three elected nominees of active TRS members employed by a public school district.

  Charlsetta Finley, El Paso (Teacher)
  Sue McGarvey, Longview (Counselor)

- One member appointed by the Governor from among three elected nominees of retired TRS members.

  Dr. Lee Williamson, Wichita Falls (Retired Superintendent)

- One member appointed by the Governor from among three elected nominees of TRS members who are currently employed by an institution of higher education.

  Dr. Kathryn Stream, Houston (Executive Director, Texas Women's University, Health Science Institute at Houston)

- Two members appointed by the State Board of Education.

  George M. Crowson, Pasadena (Retired Superintendent)
  Dana Williams (Chair), Corpus Christi (Retired Superintendent)

Organization

TRS administration budgeted 423 full time employees in fiscal 1994. Of these, 409, or 96.7 percent, were retirement program employees and 14, or 3.3 percent, were assigned to the TRS-Care program. The agency operated on a budget of $27.2 million in fiscal year 1994, and spent an additional $23 million on commissions to brokers for stock trades.

TRS is not subject to provisions in the Appropriations Act which set employment goals for minorities and women by specific job category.

The Teacher Retirement System is headquartered in Austin and has no field offices. However, TRS staff conducts counseling sessions throughout the state for future retirees. In fiscal year 1994, TRS conducted 100 group presentations in the field and spent $910,000 on benefit counseling.

The agency is divided into four divisions: executive, financial, investments, and member benefits. The *Organizational Chart* shows the staffing levels for each division.

TRS is not subject to provisions in the Appropriations Act which set employment goals for minorities and women by specific job category. Although TRS is not required to meet the state's work force goals, these goals are a useful measure of diversity and an agency's commitment to developing a diverse work force. The *TRS Work Force Chart* shows a comparison of the composition of the agency's work force with minority work force goals set in the Appropriations Act.

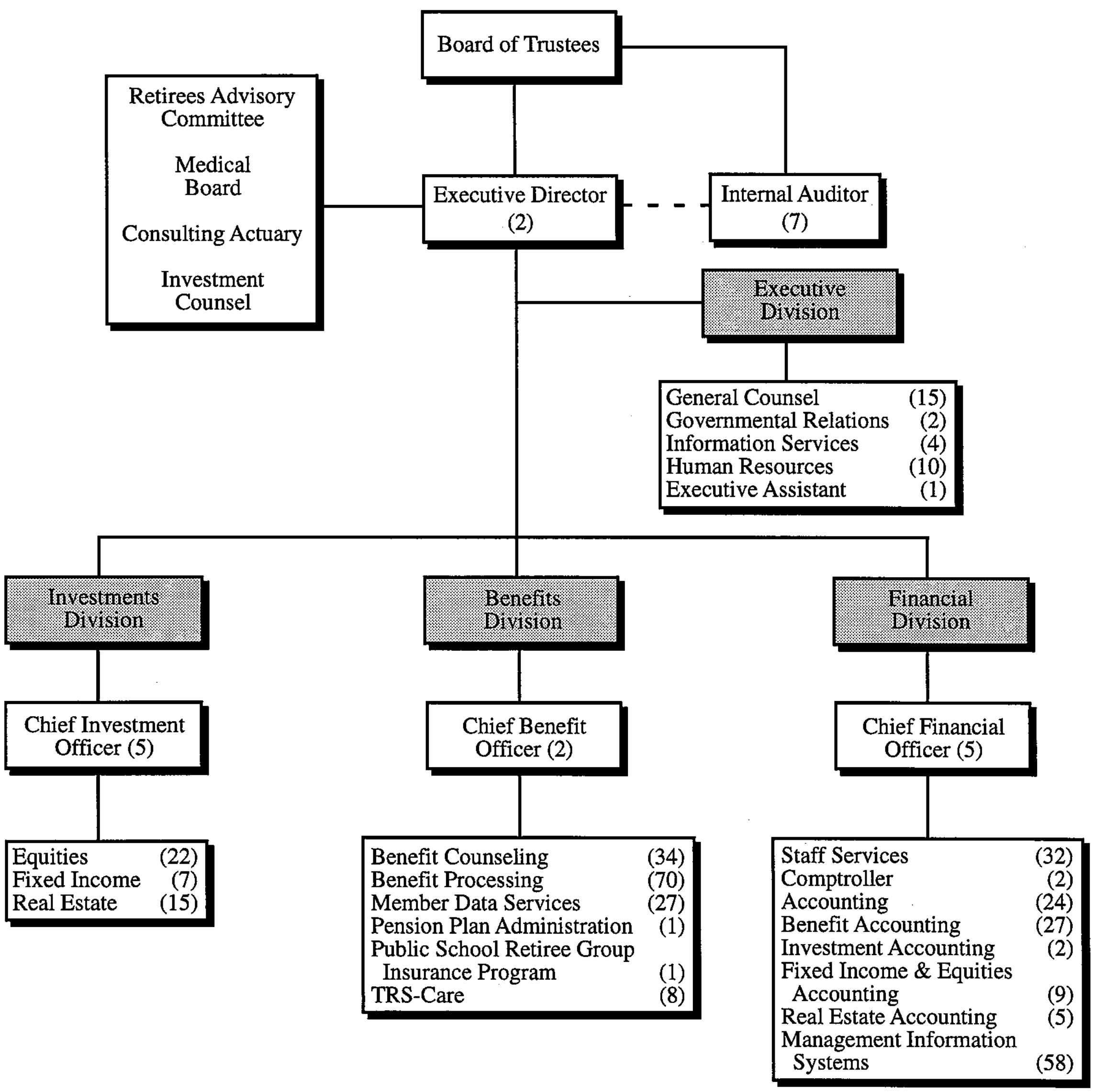
Funding

TRS Trustees are responsible for the management and investment of three separate funds: the Teacher

TRS Work Force Actual Composition
August 31, 1994

Job Category	TRS Total Positions	Minority Workforce Percentages								
		Black			Hispanic			Female		
		TRS #	TRS %	State Goal %	TRS #	TRS %	State Goal %	TRS #	TRS %	State Goal %
Officials/Administration	24	0	0.0%	5%	1	4.2%	8%	8	33.3%	26%
Professionals	139	4	2.9%	7%	13	9.4%	7%	71	51.1%	44%
Technicians	18	1	5.6%	13%	1	5.6%	14%	7	38.9%	41%
Protective Services	8	3	37.5%	13%	2	25%	18%	0	0%	15%
Para-Professionals	127	9	7.1%	25%	20	15.8%	30%	113	89%	55%
Administrative Support	73	13	17.8%	16%	18	24.7%	17%	62	84.9%	84%
Skilled Craft	6	0	0.0%	11%	5	83.3%	20%	1	16.7%	8%
Service/Maintenance	6	3	50.0%	19%	1	16.7%	32%	1	16.7%	27%
Totals	401	33	8.2%		61	15.2%		263	65.6%	

Teacher Retirement System
Organizational Chart
Fiscal Year 1995



Budgeted Employees for 1995 = 397
Total Expenditures = $27,253,564

( ) Indicates number of full-time equivalent employees assigned to that area.

In fiscal year 1994, the Fund spent $23 million on brokerage commissions and $59.5 million on the management of real estate properties and loans.

Retirement Fund; the TRS-Care Fund; and the Active Member Insurance Fund.

Teacher Retirement Fund

The Teacher Retirement Fund receives revenue from three main sources: contributions paid by members of the System based on a percentage of their salary and an annual $10 membership fee; state contributions based on a percentage of total member salaries; and investment earnings on state and member contributions. The annual $10 fee helps offset administrative costs. Revenues to the Fund in fiscal year 1994, are shown in the chart, *Sources of Revenue to the Teacher Retirement Fund.*

compensation paid to individuals participating in the System. The Legislature follows these mandates when setting the contribution rates, and in fiscal year 1994, the state contributed 7.31 percent while members contributed 6.4 percent to the Retirement Fund. State and member contribution rates are shown in the chart, *Historical Contribution Rates*.

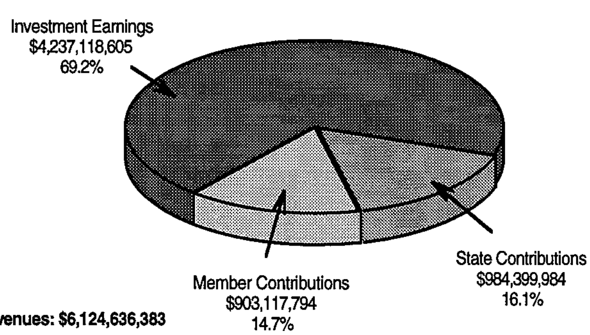
Historical Contribution Rates

Year	State	Member	Salary
1937-57	5%	5%	of 1st $3,600
1957-69	6%	6%	of 1st $8,400
1969-77	6%	6%	of 1st $25,000
1977-79	7.5%	6.65%	of 1st $25,000
1979-83	8.5%	6.65%	of total
1983-85	7.1%	6%	of total
1985-87	8%	6.4%	of total
1987-89	7.2%	6.4%	of total
1989-91	7.65%	6.4%	of total
1991-93	7.31%	6.4%	of total

Source: Pension Review Board

The Constitution sets the state contribution rate between 6 percent and 10 percent and the member contribution rate at not less than 6 percent of the total current

Sources of Revenue to the Teacher Retirement Fund
Fiscal Year 1994



Total Revenues: $6,124,636,383

The statute prohibits the Legislature from setting state or member contribution rates or authorizing new benefits if the result of any of these actions is a funding period that exceeds 31 years. The funding period refers to the amount of time it would take TRS to pay off current and future benefit obligations.

The primary use of the Fund is to pay retirement benefits to TRS members. In fiscal year 1994, the Fund paid out $1.57 billion in benefits. Other expenditures include refunds to members leaving the System, operating expenses for TRS administration, and brokerage commissions. Outflows are shown in the chart, *Expenditures of the Teacher Retirement Fund.*

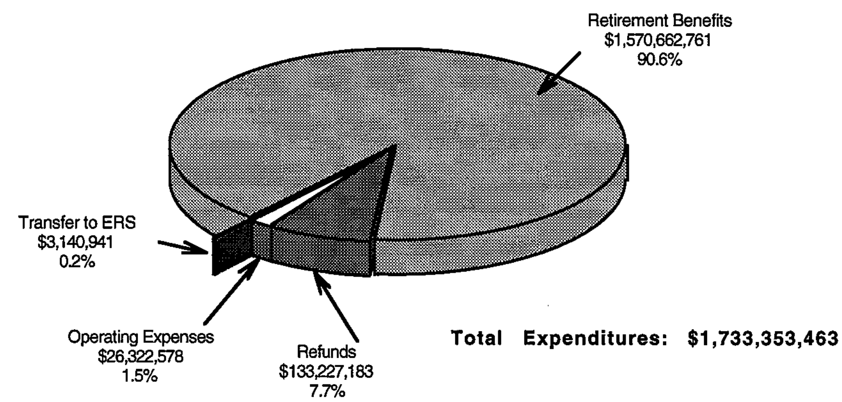
The primary responsibilities of the Trustees are to administer and invest the Fund. To carry out these duties, the System incurs operating expenses. A detailed breakout of operating expenses is shown in the chart, *TRS Operating Expenses.*

TRS operating expenses have increased significantly, particularly during odd numbered years of the last six years. The chart, *History of TRS Operating Expenditures*, shows the growth in operating expenses.

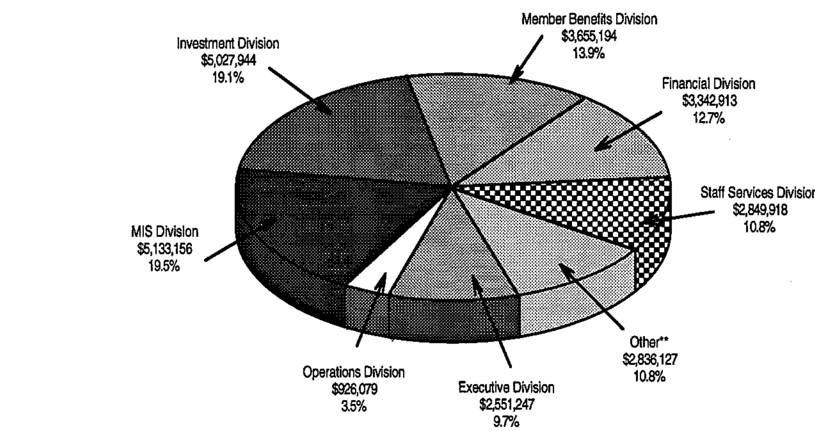
In addition to operating expenses, the Fund incurred other expenses related to investments and the management of real estate. In fiscal year 1994, the Fund spent $23 million on brokerage commissions and $59.5 million on the management of real estate properties and loans. A more detailed explanation of these expenses is provided in the box, *Investment and Real Estate Expenses.*

While TRS receives an appropriation for the state contribution, the agency is not subject to the state's strategic planning and performance budgeting process for

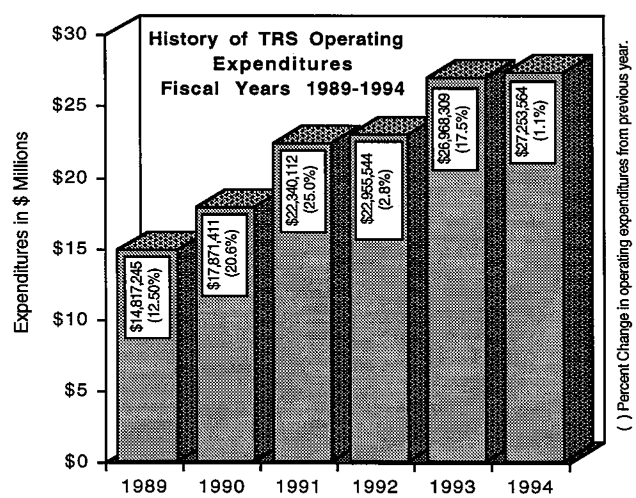
Expenditures of the Teacher Retirement Fund
Fiscal Year 1994



TRS Operating Expenses*
Fiscal Year 1994



*Includes a small amount of TRS-Care administrative expenses.
**Includes workers' and unemployment compensation, insurance costs, compensatable absences, depreciation, telephone and $41,499 for the Active Member Insurance Study.



Investment and Real Estate Expenses

To administer the System and invest the Fund, the agency incurs various expenses. These expenses include operating expenses which are detailed in the agency's budget and investment and real estate expenses which are not shown in the budget and are paid from investment income.

In fiscal year 1994, the agency spent **$27.2 million on operating expenses**. These expenses include salaries, benefits, professional services, depreciation, and postage. These expenses are documented in the agency's budget.

The agency also spent **$23 million in brokerage commissions**. These commissions are paid to stock brokers to purchase and sell stocks. Because the Fund restructured its investment portfolio in fiscal year 1994, brokerage commissions increased $14 million from the previous year. Commissions are not reflected in the agency's operating budget and are taken out of investment income.

In addition, the agency spent **$55.8 million on the management and operation of 40 foreclosed properties**. These expenditures include taxes and insurance, plant operations, and operating expenses. The Fund paid an additional **$3.7 million to real estate advisors**. Like investment expenses, these expenses are not shown in the operating budget and are taken out of investment income.

operating expenditures. The agency's operating budget is developed by the executive division and is forwarded to the Trustees for approval. TRS staff develop a strategic plan; however, there is no connection between the plan and the operating budget. The box, *TRS Strategic Plan*, shows the agency's mission statement and strategic plan.

Other Funds

In addition to the Retirement Fund, TRS manages and invests two funds designed to provide health insurance to members. The TRS-Care Fund, created by the Legislature in 1985 to provide health insurance to retirees, like the Retirement Fund, receives state and member contributions.

Members also contribute to the Active Member Insurance Fund designed to provide money to start a health insurance program for school district employees. These programs are described later in the background.

MAJOR FUNCTIONS

The activities of the agency are divided into 4 major functions:

- providing a retirement program;
- investing the System's funds;
- developing and overseeing a retiree health insurance program; and
- general administration.

Retirement Program

The retirement program administered by TRS is a defined benefit plan that provides members who meet specified conditions a life-long benefit determined by the member's length of service and salary level before retirement. The Constitution requires the Legislature to provide enough money to the Fund to guarantee that these benefit payments will be made.

The program provides retirement, disability, death and survivor benefits to employees of public schools, public colleges and universities. These employees are automatically enrolled in the retirement program with the exception of eligible higher education employees who can, instead, choose to join the defined contribution Optional Retirement Program. An active TRS member automatically contributes 6.4 percent of salary to the Retirement Fund each month.

During a member's working years little contact with the agency is needed. The agency publishes informational materials related to the Retirement System, provides active members with an annual account statement, group counseling sessions and produces a quarterly TRS newsletter. As an active member nears retirement, contact with the agency increases.

The benefits division, led by the chief benefit officer, prepares TRS members for retirement by providing individual counseling and information booklets, and by responding to inquiries about retirement benefits and procedures. The division calculates the member's retirement benefits, processes service and disability retirement claims and applications, maintains and updates retirement accounts.

TRS members become vested in the System after working five years in a school or university covered by TRS. Vesting means members qualify for retirement benefits when they reach retirement age, provided their contributions remain with, or are repaid to, the Fund.

TRS members may purchase retirement service credit for contributions withdrawn earlier or for public education or military service outside the System. The Fund allows members to purchase retirement credit for prior service that was withdrawn from the Fund, up to 10 years of qualifying out-of-state teaching service, and generally up to 5 years of military service, with some exceptions. This year, 5,953 TRS members were granted special service credit.

TRS Strategic Plan

In 1991, Texas adopted a strategic planning and budgeting process to move from short-term crisis intervention to long-term goal setting, allocate funds by priority, and improve agency accountability. The strategic plan focuses the budget process on results rather than efforts.

The administration of the Retirement Fund has not been subject to the state's appropriation in recent years and does not fully participate in the state's strategic planning and budgeting efforts. Although the trustees and staff develop a strategic plan, there is no connection between the plan and the agency's operating budget.

Mission Statement:

> "The mission of the Teacher Retirement System is to guarantee members and annuitants maximum earned benefits, courteously and efficiently delivered, through prudent management of assets held in trust for them and by promotion and administration of an actuarial sound and equitable program which will help attract and retain qualified and effective personnel for the education of the youth of the state."

Goal 1: Administer System as an Employee Benefit Trust

The agency developed two strategies to achieve this goal: pay retirement benefits/invest the funds and operate a retiree health insurance program.

The first strategy is to maintain an actuarially sound retirement system by delivering benefits to annuitants and beneficiaries in a timely manner, managing investments prudently, and communicating benefit features to active and retired TRS members.

The second strategy relates to administering the TRS-Care program by monitoring the performance of the contracted benefit provider (Aetna insurance company), communicating insurance plan features to active and retired public school employees, and resolving benefit disputes.

Goal 2: Develop Purchasing Policies to Include Historically Underutilized Businesses (HUBs)

The agency's second goal is mandated by state law: To establish and carry out policies governing purchasing contracts that foster meaningful and substantive inclusion of historically underutilized businesses.

The Legislature encourages agencies to procure no less than 30 percent of purchases from HUBs. In fiscal year 1994, the agency made 6.39 percent of its purchases from HUBs.

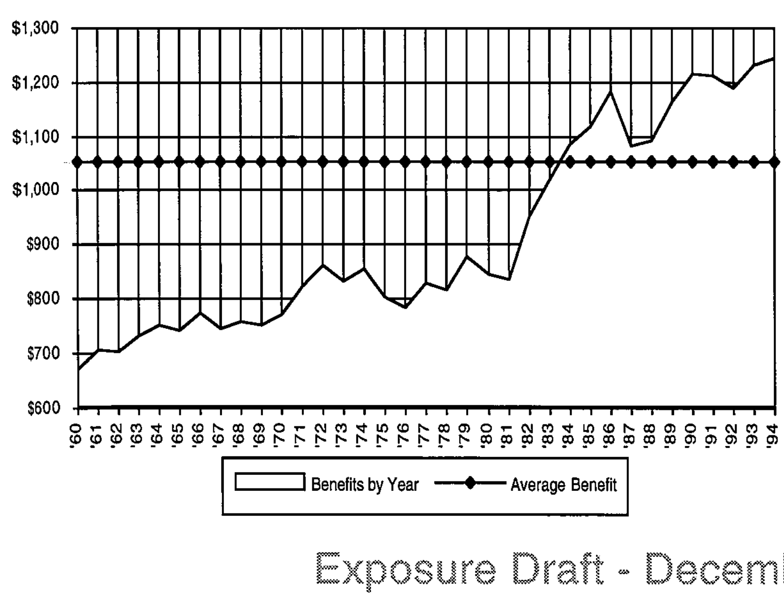
Agency Use of Historically Underutilized Businesses (HUBs) Fiscal Year 1994

Total Purchases of Goods and Services	$6,868,306
Total Spent with Certified HUBs	$438,543
Percent Spent with Certified HUBs	6.39%
Statewide Average	11.88%
State Goal	30%

A combination of age and length of service determines a person's eligibility for retirement benefits. A person can get full retirement benefits at age 65 with five or more years of service; age 60 with 20 or more years; or at age 55 with 30 or more years of service. A member can take early retirement with reduced benefits at age 55 with 20 or more years of service.

The 73rd Legislature authorized members of both TRS and the Employees Retirement System (ERS) who have service credit in both systems to combine service credits under one system at the time of retirement. This change allows retirees who have worked both in state agencies and public schools or universities to retire as if they had their retirement credit under one system for their career.

Average Retirement Benefit by Year Compared to Overall Average Benefit



The statutory formula for retirement benefits is calculated using 2 percent of the highest three-year average salary multiplied by total years of service. For example, a 55 year-old teacher with 30 years of service and an average three-year high salary of $30,000 would receive 60 percent of that salary (2 percent times 30 years) for a total of $18,000 per year.

Retirees may choose to receive their benefits under five different payment plans. Plans range from receiving the full monthly retirement benefit with benefits ceasing on the death of the retiree, to receiving a reduced monthly benefit with payments continuing to the designated beneficiary for a specified period after the death of the retiree. In fiscal year 1994, 8,369 individuals retired and began receiving service retirement benefits. Retirement benefits vary greatly among annuitants based on the year of retirement and career-high salary, as shown in the graph, *Average Retirement Benefit by Year.*

In addition to service retirements, TRS also provides disability benefits to members who are mentally or physically unable to work, regardless of age. A three-member medical board evaluates applications for disability benefits and submits the application along with a recommendation to the executive director for approval. Disability retirees can select benefit options similar to those of service retirees. About 7,181 members currently receive disability retirement benefits.

TRS also provides death and survivor benefits. Upon the death of an active member, the beneficiary may choose one of the following benefit options:

- a lump-sum payment equal to twice the member's final annual salary;
- a $60,000 lump-sum payment;
- monthly payment options based on the members' highest three-year average salary; or
- return of the member's contributions plus interest.

Upon the death of a retiree, the eligible beneficiary may choose one of the following benefits:

- a $10,000 lump-sum payment; or
- a $2,500 lump-sum payment plus, if the beneficiary is a spouse or dependent parent, $150 per month beginning immediately or upon reaching age 65, whichever is later.

In fiscal year 1994, there were 9,738 recipients of death and survivor benefits.

Investments

Over time, the Legislature has used its constitutional authority to expand the Trustees' security investment authority. In 1937, the Fund's investments were limited to government and municipal bonds. The Legislature expanded this authority in 1956 to include investments in corporate bonds and common stocks. Today, the Board of Trustees invests the Fund primarily in stocks and bonds, but also in loans secured by real estate. Information on real estate holdings is shown in the box, *Summary of the Real Estate Holdings of the Teacher Retirement System.*

With a wider variety of investment options, the emphasis of TRS investment policy is on long-term returns and diversified investments. The goal of the Fund is to maximize returns and minimize risks. The Legislature has given Trustees statutory authority to contract with private professional investment managers to assist in the management of Retirement Fund assets. Trustees are required, by statute, to have a performance measurement service evaluate the performance of investments.

The investment goal of the Fund is to maximize returns while minimizing risks.

The Trustees develop written guidelines for the investment of assets of the System and set targets for the percentage of assets that are invested in stocks, bonds, real estate mortgages, or cash. Because the risk associated with individual stocks varies greatly, Trustees approve a list of the

Summary of Real Estate Holdings

The Texas Constitution authorizes TRS Trustees to invest the Teacher Retirement Fund's assets in securities. During the real estate boom of the 1970s, the Trustees wanted to diversify Fund assets to include both loans secured by real property and actual real estate in the Fund portfolio. In 1980, Trustees instructed TRS staff to ask Attorney General Mark White for a legal opinion on such real estate investments.

Attorney General Mark White held that the Fund could invest in commercial mortgages secured by real property, but that the state constitution does not authorize the Fund to hold real property.

In response, Trustees began investing in commercial mortgages. Between 1983 and 1990 the Fund staff committed about $2.4 billion in loans secured by commercial real estate.

By 1991, the crashing national real estate market plunged many of these loans into default, despite negotiations in which TRS staff granted increasingly liberal repayment terms to the real estate borrowers.

The Fund ended 1991 holding 40 properties with appraised values totaling $209 million less than the Teachers Trust Fund was owed in loans. It remains unconstitutional for the Fund to own these properties. A proposed constitutional amendment which would have permitted the Retirement Fund to make direct real estate investments was rejected by Texas voters in 1991.

The chart, *Real Estate Loans by Year*, shows amounts of real estate loans made annually since 1982.

Because of the constitutional prohibition, Trustees formed 18 real estate-holding subsidiary corporations, each wholly owned by the Retirement Fund and overseen by a Board majority of hired staff.

In September 1992, TRS recognized the legal question posed by these subsidiaries and asked Attorney General Dan Morales about its authority to hold, improve, and dispose of foreclosed properties.

Attorney General Inquiry

The implication of the 1992 request—that TRS could hold real estate in conflict with the constitutional prohibition—raised sufficient concern that the Attorney General opened an informal inquiry into the Fund's real estate holdings and practices.

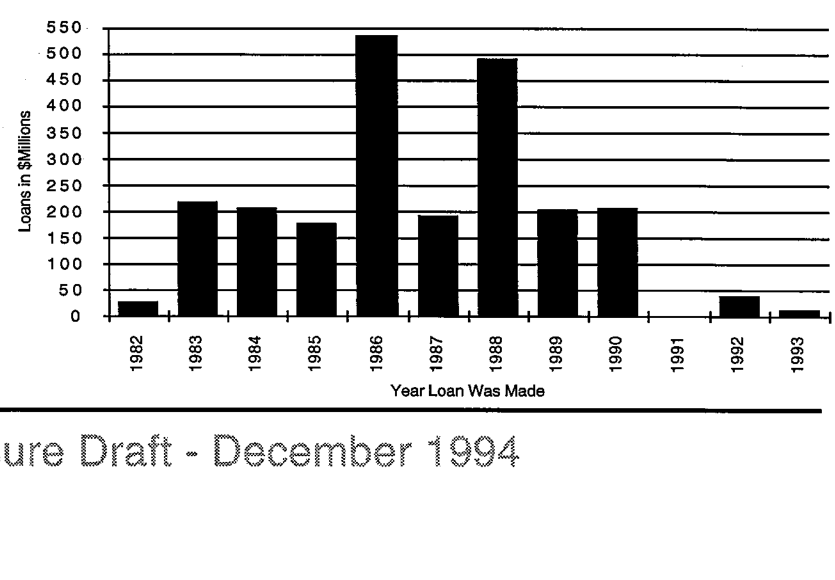
The Attorney General concluded that the TRS investment staff had made a *de facto* decision to hold foreclosed properties indefinitely, without attempting to market them, and without Board approval. The Attorney General indicated such a strategy should concern the Board since it is more speculative than financing the sale of the System's foreclosure properties.

Reporting the inquiry results to Trustees in March 1993, Attorney General Morales wrote, "As we reviewed more information, our concerns increased..."

Of the inquiry, the Attorney General reported:

- Although the Fund "experienced substantial losses associated with (real estate) investments, these losses do not threaten the fundamental solvency of the System with respect to its ability to pay the benefits of its members."
- TRS staff had used third party reports "to convey the impression that the System's real estate portfolio has had an excellent investment record. This is an impression which may be far from accurate."
- "...it is clear that certain Staff, Trustees, outside advisors and attorneys involved in the decision-making process with respect to real estate at the System, have had and may continue to have serious conflicts of interest."
- "The mere appearance of a conflict of interest, even if it has not actually unduly influenced an investment decision, causes suspicion and distrust among the System's beneficiaries and undermines the confidence they should have in the Board."
- In several of the individual transactions the Attorney General's staff reviewed, "loans have been made upon out of date appraisals, inflated appraisals or no appraisals at all."

TRS Real Estate Loans by Year



of the Teacher Retirement System

- The Attorney General reported that trust law required a Trustee taking possession of a non-legal asset to convert the non-legal or unauthorized investment to a legal one "promptly and within a reasonable time."
- "The most troubling results of this inquiry concern the conflicts of interest we continue to uncover in our review of the real estate portfolio...Many of these conflicts are widely known at the System, but a culture exists in which senior Staff treat such conflicts as of little importance, make little effort to monitor them, and have taken no serious steps to eliminate them."
- The Attorney General also reported certain findings of the inquiry to the Travis County District Attorney for criminal investigation. The resulting criminal investigation is still an open case.

Reaction to the Attorney General's report was telling.

TRS members, whose February 1993 member newsletter included a two-page report titled "Real estate a solid part of TRS investment portfolio," learned about some of the Attorney General's findings in an April 1993 newsletter article titled "Board of Trustees authorizes forensic real estate analysis." Although the article pointed out that "no current board members or senior TRS executives are implicated" in the report, it failed to mention the Attorney General's referral of some findings to the District Attorney for criminal investigation.

The TRS executive director, who had joined the retirement fund in July 1991, told the *Dallas Morning News* that he had no knowledge of the practices alleged in the report (March 13, 1993).

Attorney General Morales issued his report as the 73rd Legislature was considering Sunset Advisory Commission recommendations stemming from the first-ever Sunset review of TRS. In response, Legislators required TRS to undergo a second Sunset review. This report is the result of that second review.

Attorney General's Recommendations

The Attorney General recommended that Trustees conduct a forensic audit of the System's real estate holdings; establish a plan to dispose of the foreclosed properties; and overhaul the TRS ethics policy.

> *TRS must recover from nearly a half billion dollars in real or potential real estate losses.*

TRS has taken several steps recommended by the Attorney General to put its house in order. TRS adopted an ethics policy that addressed the concerns of the Attorney General. Trustees hired Coopers & Lybrand to conduct a forensic review of the real estate program and establish a disposition plan for the properties.

In response to the Attorney General's report and recommendations from the forensic review, TRS restructured its real estate program, formed the real estate committee of the Board, and required all decisions on real estate to be approved by the Board, instead of simply being carried out by TRS staff.

Trustees adopted a policy June 11, 1993 of placing foreclosed property on the market within five years of foreclosure, providing desirable market conditions prevail.

Present Situation

Today, the Retirement Fund has six of its properties for sale. The Fund is holding the remainder of the properties until more favorable market conditions exist for those particular properties. The System still holds $1.368 billion in loans on 34 pieces of real property. Of these 34 loans: 11 are satisfactorily making payments, 19 show signs of financial instability and four are in default. The System has placed $252 million in reserves against the possibility that more borrowers will default on loans and the System must foreclose on the property.

The $252 million in real estate loan reserves, together with the $200 million difference between the amounts owed and the appraisal values of property taken from borrowers, shows that TRS has real and potential real estate losses of nearly a half billion dollars. To reduce these losses, TRS will have to receive a significant cash flow from the properties and sell these properties at or above the loan value.

Travis County District Attorney Ronnie Earle said November 23, 1994, "Issues raised in the Attorney General's report and the private audit performed by TRS have not answered the question of criminal liability. However, much like savings and loan investigations, a team of auditors and attorneys would be required to fully investigate and unravel all the financial information and make a final determination of criminal liability. At this time, the District Attorney does not have the auditing staff to do such an in-depth financial investigation in its general state division of the public integrity unit."

While a detailed examination of each of the properties now held by the Fund is outside the scope of this review and beyond the expertise of Sunset staff, Issue 3 of this report addresses the need for objective, independent evaluation of all Fund investments, including real estate. Favorable action on this recommendation would provide a way to address concerns raised by lawmakers and the District Attorney.

To date, the Fund has experienced book losses of $209 million on its real estate acquired by foreclosure.

individual stocks for purchase by the Fund.

Led by the chief investment officer, the investments division manages the TRS investment portfolio internally and performs the actual investment transactions within Board-set guidelines. An investment portfolio is a mix of all the Fund's investments. The division staff is responsible for researching potential investments, placing orders to buy and sell, and monitoring the performance of all of the investments owned by the Fund. Staff uses brokers from a Board-approved list to buy and sell investments.

The staff also manages the System's real estate holdings—both those taken in foreclosure and the mortgage loans which are backed by real estate. These holdings include 34 active loans and 40 individual foreclosed properties. The Fund handles the management of active loans in-house and uses subsidiary corporations to hold the foreclosed properties. To date, the Fund has experienced book losses of $209 million on its real estate acquired by foreclosure.

To assist the staff in managing the assets of the System and to provide evaluations of investment performance, the Trustees employ a professional investment counsel, real estate advisors, and additional investment and real estate experts.

The Trustees use the Wellington Management Company of Boston as outside investment counsel to assist the TRS staff in the development and review of long-term investment policy. This assistance includes review of the current financial assumptions and projections used by TRS, review of past investment performance and returns, and help in establishing long-term goals and objectives. In addition, Wellington provides, at least quarterly, a written outlook on economic and market conditions, makes recommendations to the TRS staff on suggested additions and deletions to the approved common stock list, monitors purchases, and provides research support.

Trustees also contract with real estate advisors to assist in the management of owned properties and loans secured by real estate. The advisors review lease contracts, contract with property managers, and provide loan servicing and quarterly reports on loan administration.

In addition, Trustees select other private sector professionals to provide them with investment and real estate advice. These experts work with the Trustees on a consultant basis to provide professional expertise on investments and real estate decisions.

During fiscal year 1994, TRS invested the Fund as follows:

- stocks (53 percent);
- bonds (39.4 percent);
- real estate (4.3 percent); and
- less than 1 percent in the Texas Growth Fund.

The Texas Growth Fund is a program promoting economic development in the state. The remaining balance is held as cash reserves. At the end of fiscal year 1994, the market value of all TRS investments—the Retirement Fund, TRS-Care Fund, and Active Member Insurance Fund—was $38.9 billion. Investment income generated from these investments was $4.2 billion.

Over the past 10 years, TRS investments have returned 13.3 percent and over five years have returned 9.7 percent. The success of investment performance is measured in several ways. One way to measure TRS investment performance is to compare the returns of TRS investments with nationally known and commonly used market indices such as the Standard & Poor's 500 (for stocks) and the Lehman Brothers Aggregate Bond Index (for fixed income securities). These indices represent the average return for all investments by type. The Chart, *TRS Investment Returns*, shows how TRS compares with these indices.

Another way to measure TRS investment performance is to compare performance against actuarial assumptions set by the Trustees for the rate of return. TRS Trustees set the assumed rate of return at 8 percent for fiscal year 1994. During the same year, TRS investments returned 1.8 percent. While failure to meet the assumed rate of return for one or two years is not a serious problem, failure to meet the assumed rate for several years reduces the ability of the Legislature to provide benefit increases and could require the Legislature to increase contributions to meet existing benefit requirements. The chart, *Actual Returns vs. Expected Returns*, shows how TRS has performed in comparison to its assumptions.

Actual Returns vs. Expected Returns

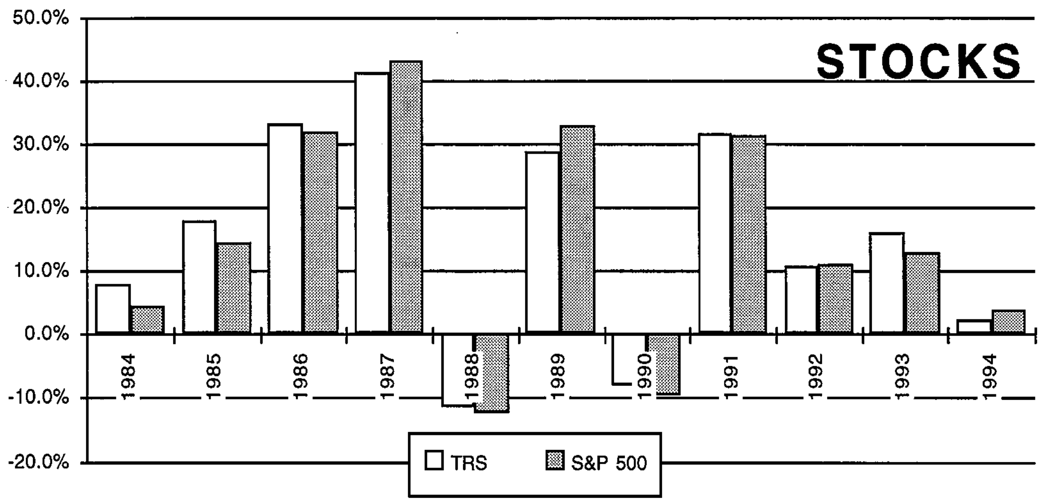
Fiscal Year	Expected Return	Actual Return
1992	9.0%	11.9%
1993	8.5%	13.4%
1994	8.0%	1.8%

Source: General Appropriations Act and TRS

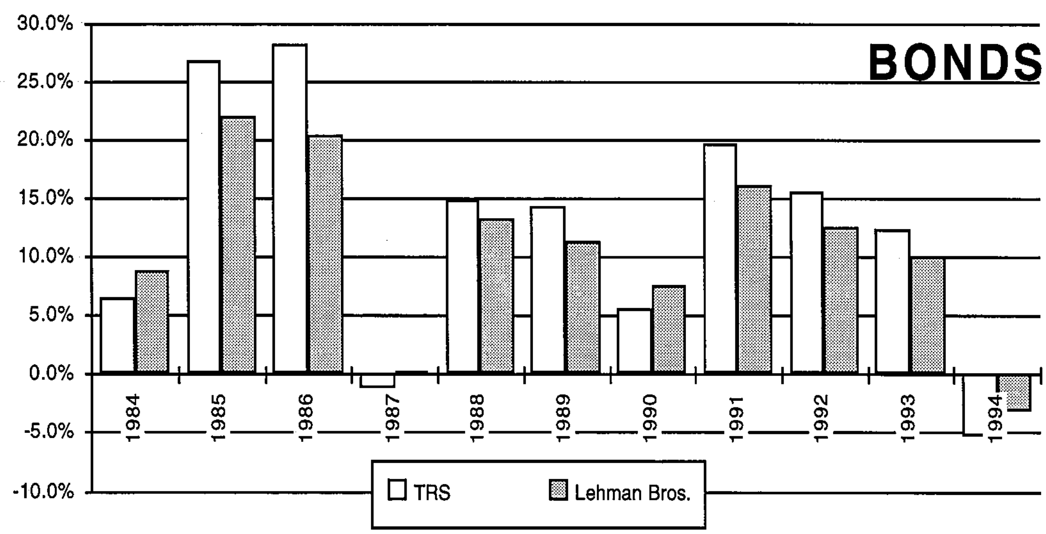
The agency is required to file a report with the Legislative Budget Board (LBB) each year showing how well investments have performed and a comparison of investment performance to nationally recognized measures. While a report must be done each year, the report is not required to be submitted to LBB by any specific date. As of December 1,

TRS Investment Returns

Time Weighted Returns* - TRS vs. S&P 500



Time Weighted Returns* - TRS vs. Lehman Bros. Aggregate Index



* As of September 30th

the LBB had not received this report.

In fiscal year 1994, the investment division employed a total of 49 staff, 22 in the equities section, 7 in the fixed income section, and 15 work in the real estate program. The division spent about $5 million in operating expenses and paid an additional $23 million in commissions to brokers. These brokerage expenses do not appear in the agency's operating budget and come directly from the Retirement Fund.

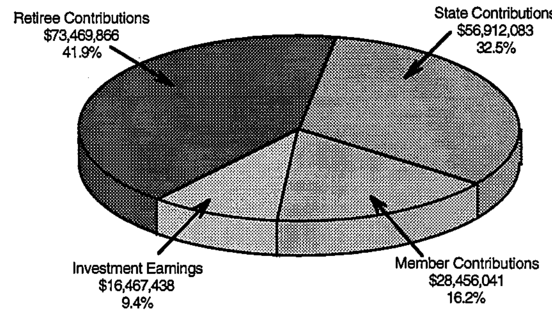
Retiree Health Insurance Program: TRS-Care

The Legislature created the Texas Public School Retired Employees Group Insurance Program (TRS-Care) in 1985 to offer health insurance coverage for retirees. This program was created because most public school districts do not offer health insurance coverage for retirees and few public school employees are eligible for Medicare.

The TRS-Care Fund is used to provide funding for basic health insurance coverage to retirees. At the end of fiscal year 1994, the total market value of the TRS-Care Fund was $244.6 million. The TRS-Care Fund receives revenue from four sources:

- a state contribution of 0.5 percent of total salaries of public school employees;
- a public school employee contribution of 0.25 percent of each employee's salary;
- payments from retirees for optional coverage; and
- earnings on investments.

Sources of Revenue to TRS-Care
Fiscal Year 1994

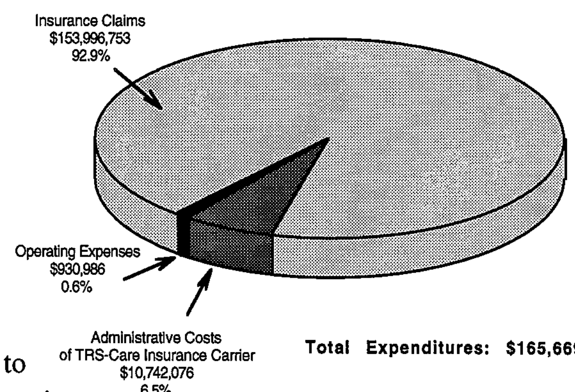


Total Revenues: $175,305,428

In fiscal year 1994, TRS-Care received about $175 million in revenue. Sources of revenue for TRS-Care are shown in the chart, *Sources of Revenue to TRS-Care.*

TRS-Care spent $165.7 million in fiscal year 1994 on insurance claims, payments to Aetna for administration and operating expenses. These expenditures are shown in the chart, *TRS-Care Expenditures.*

TRS-Care Expenditures
Fiscal Year 1994



Total Expenditures: $165,669,815

To be eligible for TRS-Care, retirees must have 10 or more years of service and not be eligible for coverage as a state employee or retiree, nor a member of a higher education group insurance plan.

TRS-Care provides three coverage options for retirees, their spouses and dependents. The benefits,

TRS-Care Benefits and Costs

	TRS-Care 1	TRS-Care 2	TRS-Care 3
DEDUCTIBLES			
Annual Deductible			
Per Person	$5,200	$2,100	$260
Per Family	$13,000	$5,250	$650
COINSURANCE AND OUT-OF-POCKET LIMIT			
Coinsurance Limit			
Per Person	$6,500	$6,500	$6,500
Per Family	$16,250	$16,250	$16,250
Annual Out-of-Pocket Limit			
Per Person	$11,700	$8,600	$6,760
Per Family	$29,250	$21,500	$16,900
MONTHLY COSTS			
Retiree Only			
With Medicare Part A	N/A	$0	$52
Without Medicare Part A	$0	$53	$158
Retiree and Spouse			
Both with Medicare Part A	N/A	$55	$161
Neither with Medicare Part A	$95	$201	$409
Retiree with/Spouse without Medicare Part A	N/A	$149	$303
Retiree without/Spouse with Medicare Part A	$37	$108	$267
Retiree and Children			
Retiree with Medicare Part A	N/A	$46	$131
Retiree without Medicare Part A	$31	$99	$237
Retiree, Spouse and Children			
Retiree and Spouse with Medicare Part A	N/A	$101	$240
Retiree and Spouse without Medicare Part A	$125	$248	$488
Retiree with/Spouse without Medicare Part A	N/A	$195	$382
Retiree without/Spouse with Medicare Part A	$68	$154	$346
Surviving Spouse Only			
With Medicare Part A	N/A	$55	$109
Without Medicare Part A	$95	$149	$251
Surviving Spouse and Children			
Surviving Spouse with Medicare Part A	N/A	$101	$188
Surviving Spouse without Medicare Part A	$125	$195	$330
Surviving Children Only	$31	$46	$79
BENEFITS			
Basic Benefits after Annual Deductible: TRS-Care pays 80% of most covered expenses - enrollee or dependent pays 20%. After total annual out-of-pocket limit is reached, TRS-Care pays 100% of covered expenses for the remainder of the plan year.	Yes	Yes	Yes
Hospital and Physician Network: Enrollee or dependent pays reduced charges based on a TRS-Care fee schedule.	Yes	Yes	Yes
Prescription Drug Benefits	Plan Pays 80% After Annual Plan Deductible	Plan Pays 80% After Annual Plan Deductible	Increased Benefits*

* TRS-Care 3 members may buy discounted drugs through a mail order prescription program for a $2 co-payment for generic drugs and a $10 co-payment for brand name drugs. Also available is a retail program that includes a $50 prescription deductible and pays 70% for brand name prescriptions and 90% for generic prescriptions.

deductibles and costs of the three options are shown in the chart, *TRS-Care Benefits and Costs.*

TRS-Care 1 provides basic catastrophic health insurance coverage at no cost to all eligible Texas public school retirees who do not have Medicare Part A, which covers hospitalization costs. Because most school districts in Texas do not participate in the Social Security system, many TRS members do not receive Medicare benefits. Of those that do qualify for Medicare and other Social Security benefits, most are spouses of Social Security system participants. If a retiree does have Medicare Part A hospitalization benefits, they receive TRS-Care 2 at no cost. TRS-Care 2 has lower deductibles than TRS-Care 1. Both TRS-Care 1 or 2 can be purchased by retirees for spouses and dependents. Both plans pay 80 percent of medical costs, including prescription drugs, after the retiree meets the deductible.

TRS-Care 3 offers comprehensive medical insurance coverage to all eligible Texas public school retirees, surviving spouses and dependents for an additional charge. Because TRS-Care 3 has a lower deductible and offers more benefits than TRS-Care 1 or 2, the monthly premium payments are considerably higher for TRS-Care 3 participants than for participants in the other two plans. TRS-Care 3 offers a low-cost mail order pharmacy service that is not available in the other plans.

As of August 31, 1994, total enrollment in all TRS-Care plans was 108,036 persons including 93,162 retirees, 1,585 surviving spouses and children, and 13,289 dependents. The chart, *TRS-Care Participants by Option Category* illustrates retiree choices of plans.

TRS-Care Participants by Option Category

	TRS-Care 1	TRS-Care 2	TRS-Care 3	Total
Retirees	16,112	19,494	57,556	93,162
Surviving Spouse	27	83	1,450	1,560
Surviving Children	0	0	25	25
Dependents	293	885	12,111	13,289
Total	**16,432**	**20,462**	**71,142**	**108,036**

The benefits division oversees the administration of the TRS-Care program. Claims services are provided by an independent insurance company and the contract for these services is awarded for six years. Aetna, the insurance company that won the bid in 1992, administers the TRS-Care program, including setting premiums, paying claims and pre-certifying medical procedures. The TRS-Care staff oversees Aetna's administration of the program and provides policy direction to Aetna when needed. Agency staff work with TRS members to explain the TRS-Care program. In fiscal year 1994, Aetna processed 1,636,545 claims

TRS-Care provides catastrophic health insurance coverage at no cost to Texas public school retirees.

The TRS-Care Fund is a distinct trust fund separate from the TRS Retirement Fund. Like the Retirement Fund, the TRS-Care Fund is managed by the staff of the investments division.

and received $10.7 million for administering the program.

TRS-Care transfers funds to Aetna on a weekly basis to reimburse for claims paid during the week and also pays Aetna for operating costs and risk and profit charges each month.

The TRS-Care Fund is a distinct trust fund separate from the TRS Retirement Fund. Like the Retirement Fund, the TRS-Care Fund is managed by the staff of the investments division.

Because of federal and state restrictions on the use of pension funds for non-pension purposes, TRS-Care reimburses the Retirement Fund for legal, data processing, telephone, and other services provided by the System and pays rent to the Fund for the use of office space. In fiscal year 1994, TRS-Care reimbursed the Fund $105,502 for these services.

Trustees appoint a nine-member Group Insurance Advisory Committee to advise the Trustees on changes needed to the TRS-Care program. The nine members must include one active school administrator, one retired school administrator, two active teachers, three retired teachers, one active auxiliary employee and one retired auxiliary employee. The advisory committee holds public hearings on group insurance benefits and recommends potential changes to the TRS Trustees.

TRS Health Insurance Survey

TRS active members were charged a $10 fee to provide money to start a health insurance program for school district employees. This fee was deposited in the TRS Active Member Insurance Fund. At the end of fiscal year 1994, this fund contained $4.9 million in member fees and interest income. TRS staff used $41,499 to pay for a legislatively-required study to measure interest in a statewide health insurance program for active members.

This fund will serve as a reserve fund for an active member health insurance program, if the program is authorized by the Legislature. If the insurance program is not authorized, the monies in the fund will be rebated to active members.

In June 1994, the Legislature received the findings of the required study in the report, *Health Insurance for Public School Employees and Retirees*.

The study included a survey that found that 96 percent of public school employees have access to health insurance through their school district, although costs to individuals vary greatly. Almost half of the responding school districts (42 percent) indicated interest in a voluntary statewide health insurance plan.

In terms of TRS-Care, results of the survey showed that about two-thirds of retirees are somewhat satisfied or very satisfied with the TRS-Care program. The study did not address quality of care issues.

The agency recommended requiring all or some districts to participate if a statewide health care plan was developed. The report made no recommendations on how to decide which districts should participate. The report laid out options for funding a health plan—on a per capita basis or as a percent of participants' payroll. TRS did not recommend who should provide funds for the program, just how funding could be calculated.

General Administration

Two of the four divisions provide overall support to the agency's main functions: the retirement program, investments, and TRS-Care. These divisions are the executive division and the financial division.

The executive division, headed by the executive director, is charged with ensuring that the agency operates in accordance with state and federal laws and with policies developed by the Trustees. The division develops and implements policy goals and objectives and plans for achieving them, recommends investment policies to the Board, and prepares the annual operating budget for the retirement program and TRS-Care. The executive division includes governmental relations, general counsel, information services and human resources.

The financial division handles the agency's accounting, budgeting, payroll, and purchasing requirements and produces the annual financial report. The division manages staff services which include mail, supply, printing and binding, as well as physical facilities, mechanical equipment, grounds, security and safety.

The division is also responsible for management information systems including all electronic data processing and communications functions.

To ensure that the TRS assets are safeguarded and that proper financial controls are in place, the agency uses an internal auditor. Using a risk-assessment model, the internal auditor identifies those areas that pose the greatest risk to TRS' operations and efficiency and conducts audits in those areas.

APPENDIX 1

Review of the Actuarial Assumptions of the Teacher Retirement System of Texas

prepared by:

Coopers & Lybrand L.L.P.

November 1, 1994

Coopers & Lybrand

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a professional services firm

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November 1, 1994

Mr. John Keel
Director
Legislative Budget Board
Box 12666, Capitol Station
Austin, Texas 78711-2666

Dear Mr. Keel:

As requested, Coopers & Lybrand has performed a review of the actuarial assumptions of the Teacher Retirement System of Texas. This report describes the process we followed and summarizes our findings.

Respectfully submitted,

COOPERS & LYBRAND L.L.P.

John H. Grady

John H. Grady
Fellow of the Society of Actuaries
Enrolled Actuary (Number 93-445)

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Table of Contents

Section I - Introduction and Summary

Coopers & Lybrand L.L.P. (C&L) has been engaged by the Legislative Budget Board (LBB) to review the actuarial assumptions of the Teacher Retirement System (TRS). Specifically, we have been asked to address the following issues:

Does TRS use a reasonable method for establishing assumptions?

Are TRS actuarial assumptions reasonable; individually and collectively?

Is the process TRS follows in establishing its assumptions sound?

- What process does the TRS actuary follow in determining assumptions?
- Who is involved in establishing assumptions?
- Are there any guidelines for establishing assumptions that should be followed; if so, does TRS adhere to them?

We performed the following tasks in the performance of this assignment:

1. Interviewed the Chairman of the Board of Trustees of the TRS.
2. Interviewed the actuaries at The Wyatt Company (Wyatt).
3. Reviewed Wyatt 's work files associated with the 1990 Experience Study (5 years of experience) and 1994 Review of Experience (3 years of experience).
4. Interviewed the TRS in-house actuary responsible for generating the plan experience reports used by Wyatt.
5. Reviewed TRS law and actuarial standards related to actuarial assumptions.

Section I - Introduction and Summary
(continued)

Based on our review, we have concluded that the assumptions recommended by the actuary are reasonable and that the process followed in setting assumptions is in compliance with TRS law and professional actuarial guidelines. Nonetheless, we recommend the following changes and actions be made to improve the process:

1. The payroll growth assumption should be reviewed thoroughly.

2. The experience reports should include only those active members who are retirement eligible in the calculations which compare expected retirement experience to actual retirement experience.

3. Incomplete data records should be excluded from the experience studies rather than included with default values.

These recommendations are discussed in more detail in the following sections.

Section II - Process

Section 825.105 under Title 8 of the Texas Civil Statutes describes the responsibilities of the TRS board and the actuary regarding the choice of assumptions. Specifically:

> "The board of trustees shall adopt rates and mortality, service, and other tables the Board considers necessary for the retirement system after considering the results of the actuary's investigation of the mortality, service and compensation experience of the system's members and beneficiaries."

Also, Section 825.206 states:

> "(b) At least once every five years the actuary, on authorization of the board of trustees, shall:
>
> (1) investigate the mortality, service and compensation experience of the members and beneficiaries of the retirement system;
>
> (2) on the basis of the investigation made under Subdivision (1), recommend to the board of trustees tables and rates that are required ... "

We reviewed the process used by the actuary and the board to determine the assumptions and methods used by TRS. This process involves five steps:

(1) TRS prepares experience reports based on information in their participant data base.

(2) Wyatt analyzes the experience reports and, based on this information, develops assumption recommendations with respect to decrements (the assumed probability that active members will leave due to retirement, withdrawal, disability or death). With respect to economic assumptions, Wyatt reviews economic information, including salary history data in the experience reports, and develops economic assumption recommendations.

(3) Members of the TRS Staff review the assumption recommendations and provide input to Wyatt regarding views of future trends, etc.

(4) Based on this input, Wyatt finalizes the assumption recommendations, and submits them to the board.

(5) The board reviews Wyatt's recommendations and adopts assumptions deemed appropriate.

Section II - Process
(continued)

TRS maintains the data necessary to administer the plan including experience data. On an annual basis, the in-house actuary generates two reports from this database which summarizes the plan experience for two periods. The first report summarizes experience for the prior year; the second report summarizes experience since the last quinquennial experience study.

These reports summarize, for each age and service group for whom separate assumptions apply, the number of active members in the group, the number who were expected to leave due to a specific cause (i.e., withdrawal, death, disability or retirement) and the number who actually did leave due to that cause. These reports also generate actual to expected (A/E) decrement ratios for each of these age and service groups.

We reviewed the report generation process with Tony Huang, the in-house actuary for TRS. Tony is responsible for producing the reports and, in concert with Wyatt, reviewing the reports to verify the accuracy of the data. If specific data items are missing from individual records, Tony uses default values provided by Wyatt.

The TRS law requires, at a minimum, quinquennial review of the assumptions. Wyatt reviews the experience data on an annual basis. If actual plan experience tracks the assumed experience closely, experience studies are performed quinquennially. If, however, the actuary believes that the plan experience is diverging from the expected experience, the actuary may request board approval to perform an interim experience study.

In performing an experience study, the Actuary uses the A/E ratio described above to determine whether the number of active members expected to leave (equal to the number of active members exposed to that decrement times the probability of decrement assumed) is approximately equal to the number of active members who actually left due to that cause. As an example, let's say that over the three year period, 10,000 male active members where at some time in that period in the group aged 40 with seven years of service. Under the old assumptions, the assumed probability of withdrawal at age 40 with seven years of service was .0539. Therefore, we would expect that 539 members withdrew during the three year period. If the actual number of active members withdrawing from that group differed substantially from 539, the actuary would probably recommend changing the assumed probability of withdrawal such that the expected number of withdrawing active members will be closer to 539.

Wyatt determines whether the actual experience for the decrement differs materially from the expected experience. Wyatt's practice is to make a ratio adjustment to the existing decrement assumptions based on the ratio of actual experience to expected experience; the adjustment includes a margin in the modified A/E ratio of approximately 5% for conservatism.

Section II - Process
(continued)

With respect to economic assumptions, Wyatt reviews historical data on inflation, rates of return on different asset classes and salary experience. They consider input from economist and other financial experts; and, applying judgment, they determine their future long-term expectations.

After determining preliminary recommendations, Wyatt reviews these recommendations with certain staff members of TRS. TRS provides input regarding their expectations of how future trends will effect the assumptions, such as staffing projections, turnover, and salary increases. In addition, TRS staff provides input on economic assumptions.

After reviewing TRS input, Wyatt finalizes recommendations that are then presented to the board. After the board has discussed the assumptions, they decide which changes, if any, to adopt. We discussed this approval process with Wyatt, and as far as they can remember, the board has always approved the recommendations made by the actuary.

Section III - Current Assumptions

Decrement Assumptions

We reviewed the experience reports generated by TRS and the work files created by Wyatt for the 1990 and 1994 decrement studies. We found this work to have been performed properly and the decrement assumption changes that Wyatt proposed to be reasonable.

In reviewing the experience reports provided to Wyatt by the TRS staff, we discovered the following issue. In determining the number of active members who are exposed to the decrement of retirement, it is appropriate to include only those active members who are actually eligible to retire. In the experience report, active members with less than five years of service were included in the number of active members exposed to the retirement decrement. Since at least five years of service are required to retire from TRS, this error would overstate the number of expected retirements for active members over the age of 55. Since the group included in error is only active members hired after the age of 50, we expect the error to be minor.

Following are items we found in our review of Wyatt's workfiles which we regard as discrepancies in the experience study process in the 1994 Experience Study. Neither of these issues is significant.

1. The new assumption for male retirement decrements produces a total A/E of 116% (105% for females) which is somewhat higher than Wyatt's stated objective for the process.

2. Wyatt requested that TRS correct records with missing data by filling those fields with default values. In our opinion, it is preferable that incomplete records be excluded rather than using default information for experience study purposes.

Section III - Current Assumptions
(continued)

Economic Assumptions

Inflation

Wyatt recommended changing the inflation assumption from 5% to 4.25% in the 1994 study. Wyatt presented the following reasons behind this recommendation:

1. Average inflation in the past three years was 3.1%, based on the CPI W table

2 Historical inflation rates averaged 3 to 4%

3. Certain economic forecasts project 4 to 4½% future long term inflation

In our opinion, this recommendation was reasonable.

Salary Scale

The salary scale is made up of three components

1. Inflation (discussed above)
2. productivity
3. step rate/promotional

Wyatt's process is to review the current salary increases under the plan for active members grouped by years of service net of inflation. The excess of salary increases over inflation for longer service active members is used to measure the productivity component based on the theory that step rate/promotional increases are deminimus for such active members. Increases in excess of both the inflation and productivity are used to test the step rate/promotional component.

Wyatt found that actual salary increases for longer service active members were lower than expected by about .25%. Wyatt also believed that future governmental budgetary constraints would continue to dampen general salary increases for teachers. As a result, Wyatt recommended decreasing the assumption for the productivity component from .75% to .50%.

After adjusting for actual inflation and the apparent decrease in the productivity component, Wyatt concluded that the step rate/promotional component actually experienced compared closely to the current assumption and recommended no change.

In our opinion, the recommendation to reduce the productivity component and not change the step rate/promotional component was reasonable.

Section III - Current Assumptions
(continued)

Rate of Return

To test the real rate of return assumption, Wyatt examined the current asset mix of the TRS trust and calculated the returns a trust with that asset mix would have generated in the past. This was done in quinquennial year groups starting in 1926. Wyatt found that, for the given asset mix, the historical average nominal rate of return was 8.15% and the historical average real rate of return was 4.96%. Wyatt recommended that the real rate of return assumption be increased from 3% to 3.75%. The rationale given for the value being well below 4.96% was the expectation that future real rates of return will be lower than the past.

In our opinion, the recommendation to increase the real rate of return from 3% to 3.75% was reasonable, but somewhat conservative.

Payroll Growth Rate

The assumed payroll growth rate is 6%. Experience in the past ten years is generally consistent with this assumption. No change was recommended in the 1994 Review.

The payroll growth assumption can be broken down into two separate components. The first is the general salary increase assumption (i.e. inflation plus productivity). The second is the expected increase in the number of active members. Implicit in a 6% payroll growth assumption, given a 4.75% general salary increase assumption, is a 1.25% annual active population growth assumption. Information regarding projected trends in Texas population demographics, (e.g. numbers of students, required number of teachers) should be examined as part of the process of setting this assumption.

We do not take exception to the reasonableness of the current assumption. However, it appears that relatively little attention was given to it. Since it is a significant assumption, we recommend that thorough consideration be given to it.

Actuarial Asset Valuation Method

In the 1994 Review, Wyatt recommended changing the asset valuation method to one that was better suited to the trust's investment strategy. The prior method recognized unrealized gains over a period of five years. This would be an appropriate method when the investment strategy required little turnover of equities, since the volatile element of equity pricing would be smoothed. However, given an investment strategy involving higher turnover of equities, and therefore more frequent recognition of equity gains, this method would result in an actuarial value of assets that would be as volatile as the market value.

Section III - Current Assumptions
(continued)

Wyatt therefore proposed a valuation method where all asset returns in excess of or less than that assumed would be recognized over a five year period.

In our opinion, the new method is reasonable and appropriate.

Reasonableness Between Economic Assumptions

The spread between the investment return assumption and the salary scale was widened in 1994 by 1% (from roughly .75% to 1.75%). While this change is in the direction of less conservatism, we believe the spread is still somewhat conservative.

Section IV - Professional Guidelines

Actuaries are guided in their choice of assumptions by standards established by the Actuarial Standards Board (ASB).

Actuarial Standard of Practice No. 4, Section 5.2.4, states:

> "The actuarial assumptions individually and in combination should reflect the actuary's best judgment. The actuary should consider the actual experience of the covered group but should emphasize expected long-term future trends rather than give undue weight to recent past experience ..."

The ASB has also issued an exposure draft that specifically addresses the choice of economic assumptions. Section 5.3 of that draft states:

> "General Considerations - When selecting economic assumptions for a specific measurement, the actuary should consider the following factors:
>
> a. the purpose and nature of the measurements;
>
> b. the characteristics of the obligation to be measured (duration, open/closed group, etc.); and
>
> c. appropriate historical and current economic data.
>
> The actuary should consider current economic data. However, the actuary should emphasize appropriate future long-term expectations rather than give undue weight to recent past experience. For example, if the recent investment return was largely attributable to a significant change in the interest or inflation rate, it may be unreasonable to assume such inflation rate, it may be unreasonable to assume such investment returns will continue in the long term."

After review of the process that Wyatt used to analyze the data and to select their recommended assumptions, it is our opinion that Wyatt has determined the actuarial assumptions for TRS in compliance with these professional guidelines.

APPENDIX 2

Teacher Retirement System Fact Sheet

Claim: *Legislators want to use Teacher Retirement funds to "pay off state debts."*

Fact: The Texas Constitution prohibits the Legislature from using Teacher Retirement funds to "pay off state debts." The Constitution specifically places Teacher Retirement System funds in a trust solely for the benefit of members and prohibits Teacher Retirement funds from being diverted for any other purpose. Although some other states have used retirement funds for other purposes, this is clearly prohibited in Texas.

Claim: *Teachers will suffer if the state contribution rate to Teacher Retirement is lowered.*

Fact: The Teacher Retirement is a defined benefit system. This means that changes in the rate of state contributions set by the Legislature don't affect the obligation to pay retirement benefits under the System. The state and the Teacher Retirement System are mandated to pay your benefits regardless of other financial needs of the state.

As Dr. Gary Thompson of the Teacher Retirement System staff said on Capitol Watch, "Texas lawmakers have never seriously considered measures that would jeopardize the actuarial soundness of the System, nor do we anticipate such action in the future."

Historically, the Legislature has provided significant funding for benefit increases for retirees. The Legislature has provided increases during every legislative session since 1975, except in 1985. In 1993, the Legislature authorized over $625 million in teacher retirement increases.

Claim: *Teachers ought to be treated like state employees in the Employees Retirement System and receive a constant 8 percent state contribution toward retirement.*

Fact: The present state contribution rate to Teacher Retirement is 7.31 percent, while the state contribution rate to the Employees Retirement System is 6.45 percent. Although the Employees Retirement System has a temporary retirement multiplier of 2.25 percent for new retirees which expires in 1995, the permanent multiplier is 2 percent, the same as the Teacher Retirement multiplier. The state Constitution charges the Legislature with maintaining both the Employees Retirement System and Teacher Retirement System as financially sound retirement funds and contributing between 6 and 10 percent of salaries to ensure financial soundness.

Claim: *Teacher Retirement System has "lost $9 million to the Employees Retirement System."*

Fact: In 1993, the Legislature authorized the educational employees of several agencies to transfer their retirement from Teacher Retirement to the Employees Retirement System. Those employees eligible for retirement, who had paid into Teacher Retirement for many years, could choose to retire under the Employees Retirement System temporary 2.25 multiplier instead of the Teacher Retirement System 2.0 multiplier. Teacher Retirement published a statement that the cost of paying the early retirement incentive for *Employees Retirement System members* is approximately $9.1 million. However, the $9.1 million would represent the total cost of this differential many years into the future for former members of *Teacher Retirement* who transferred to the Employees Retirement System. The $9 million has not been transferred to the Employees Retirement System.

When contacted by Sunset staff, Teacher Retirement indicated that the $9 million figure may actually be less, but new figures were not yet available. When Sunset staff estimated a much lower figure, Teacher Retirement then reported that $338,240 has been sent to the Employees Retirement System for the higher multiplier. These dollars represent payments for the 331 former Teacher Retirement members that retired under the Employees Retirement System with the higher multiplier this year. Most importantly, these increased benefits go to educators who were long-time members of Teacher Retirement; none goes to Employees Retirement System members who were never part of the Teacher Retirement System.

Claim: *The Legislature can increase the multiplier for retirement benefits to 2.2 percent at no additional cost to the state.*

Fact: In June, the Teacher Retirement System trustees dramatically reduced their estimate of how much it will cost to pay members' retirement payments in the future. This change raised hopes that, if the Legislature continued to appropriate a state contribution of 7.31 percent, the multiplier could be increased to 2.2 percent as well as provide some retirees increased benefits. Today, however, the Teacher Retirement staff says such increases "may or may not be affordable." The Teacher Retirement System plans to revise its estimates of future costs in December and again in February.

When asked by the Legislature what the state contribution rate needs to be to ensure the fund remains sound, Teacher Retirement responded that the state could reduce its contribution rate to 6 percent and still have more than $700 million left for a retirement benefit increase.

Claim: *The Sunset Commission is considering moving Teacher Retirement System management under control of the Legislature.*

Fact: As a with all state agencies, Teacher Retirement's management is already subject to legislative oversight. As one part of that oversight, the Sunset Commission is performing a legally-required review of the Teacher Retirement System. The review includes looking at the efficiency and effectiveness of Teacher Retirement System management and operations to insure that educators' retirement funds are used wisely. However, the State Constitution prohibits the Legislature from "taking over control" of Teacher Retirement because the Constitution requires a Board of Trustees to administer the funds.

Claim: *The Sunset Commission is planning to recommend capping benefit payments at $3,500 to $4,000 per month.*

Fact: At least one education association has been led to believe that the Sunset staff was considering a recommendation to cap benefit payments of highly compensated retirees. This claim was probably made because the Sunset Staff requested information on the 68 retirees receiving between $6,000 and $11,800 per month from Teacher Retirement. This request was part of an analysis of the range of retirement payments—a range that includes a large number of retirees receiving less than $200 a month from Teacher Retirement.

Sunset staff is not considering a recommendation to cap benefits. In fact, the Sunset staff believes that such an action could be illegal, and certainly inappropriate. The state has entered into a contract with all members of the Teacher Retirement System to provide retirement benefits at the levels set out in state law at the time of retirement. The state has an obligation to fulfill the contract.

Teacher Retirement System of Texas

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