

**EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**TEACHER RETIREMENT SYSTEM OF TEXAS**

**October 1992**

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## SUMMARY

The Employees Retirement System (ERS) and the Teacher Retirement System (TRS) are subject to review under the Sunset Act, but are not subject to abolishment under that Act. As a result, the review did not focus on an evaluation of the need for the agencies. However, as required by statute, the review examined the benefits to be gained by reorganizing the agencies and if current statutory policies could be changed to improve the efficiency and effectiveness of the agency.

### Need for the Agency

The ERS and the TRS are established by the Texas constitution. Any change affecting the continuance of their operations must be accomplished through a constitutional amendment. In addition, the agencies are not subject to abolishment under the Sunset Act. Therefore, the review did not examine whether there is a continuing need for the functions of the ERS and the TRS.

### Reorganization Alternatives

As part of the review, various reorganization options were considered to determine if any of the agencies' functions could be transferred to another agency. The review showed that the ERS and the TRS perform several similar functions. However, constitutional provisions and the significant infrastructure in place to operate the agencies would pose difficulties to achieving major combinations of functions. The review did show, however, that the potential exists for cost savings to the two systems if some activities were combined. A policy option in the overall administration section of the report discusses requiring the agencies to evaluate potential cost savings from combining similar functions and reducing duplication through interagency contracts.

### Policymaking Body

- The size of the ERS Board of Trustees could be increased to nine members by adding members with investment and health insurance expertise.

### Overall Administration

- The administration of the agencies could be modified by:
  - requiring ERS and TRS to evaluate similar activities to determine if there are potential cost savings from combining the activities; and
  - placing ERS and TRS under the Appropriations Act.

## Evaluation of Programs

- The operation of the agencies' programs could be improved by:
  - allowing transfer of service credit between ERS and TRS;
  - providing a mechanism for implementation of the health insurance program for school district employees;
  - removing ERS' statutory investment constraints on the Law Enforcement and Custodial Officers Retirement Fund;
  - allowing ERS' retirement funds to be combined for investment purposes;
  - abolishing higher education employees' optional retirement program;
  - providing biennial funding for TRS-Care; and
  - establishing a cost-of-living adjustment mechanism for TRS retirees.

## Fiscal Impact

None of the policy options in the report would have a *direct* impact on the General Revenue Fund. However, it should be noted that any changes adopted by the legislature that have a significant impact on the retirement funds could result in changes needed in the appropriations necessary to support those funds.

Preliminary estimates indicate that allowing the combination of ERS-managed funds for investment purposes would save approximately \$158,000 per year. Several of the other policy options are expected to save money; however, the amount of savings can not be estimated. These options include reducing duplication through interagency contracts, placing ERS and TRS under the Appropriations Act, and removing investment restrictions on the LECOSRF. In addition, abolishing the optional retirement program could save universities up to \$14.9 million in local funds.

Three of the policy options may involve costs to the retirement systems. Expanding the ERS board to nine members is expected to cost about \$8,000 per year. Allowing transfer of service credit between the ERS and the TRS and establishing a cost-of-living adjustment mechanism for TRS retirees could result in increased costs to the retirement funds. However, these costs can not be estimated until the details of the options, if adopted, are developed by the agencies.

<b>Fiscal Year</b>	<b>Net Gain to ERS-Managed Funds</b>
1994	\$149,700
1995	\$149,700
1996	\$149,700
1997	\$149,700
1998	\$149,700



**EMPLOYEES RETIREMENT SYSTEM OF TEXAS**



## CREATION AND POWERS

The Employees Retirement System of Texas (ERS) was created in 1947 by an amendment to the State Constitution (Article XVI, Section 67). The original purpose of the system was to provide a retirement, disability, and death compensation fund for the appointed officers and employees of the state. Texas, along with 21 other states, maintains separate retirement systems for its state employees and teachers. Currently, the ERS has over 130,000 active members and nearly 28,000 retirees, making it the 32nd largest public pension plan in the United States.

The duties and responsibilities of the system have been significantly expanded since 1947. The Death Benefits Program for Certified Law Enforcement Officers, Firemen and Other Eligible Persons became operational in April 1967. This program is designed to provide financial assistance to beneficiaries of persons who suffer violent deaths in the performance of their duties. In September of 1976, the state began operation of the Texas Employees Uniform Group Insurance Program (UGIP). Its objective is to provide uniformity in life, accident, and health benefits for state employees, elected officials, judges, retirees and their eligible dependents. In 1988, the system began administering the state's flexible benefits program or TexFlex. This is a program designed to allow participating employees to reduce federal taxes on that portion of their salaries which pays for eligible insurance premiums, health care expenses, and dependent care costs. The last responsibility added to the system was the state's deferred compensation program which was transferred from the comptroller's office in January 1991. This program allows state employees to make pre-tax contributions to supplemental retirement plans to help ensure financial security upon retirement. As can be seen by these changes, the mission of the ERS reflects increased employee benefit activities over the last 25 years.

## POLICYMAKING BODY

The Employees Retirement System of Texas is headed by a part-time, six-member Board of Trustees. Three members of the board are nominated and elected by the members and retirees of the system. The speaker of the house of representatives, the chief justice of the state supreme court, and the governor each appoint one member with the advice and consent of the senate. The members serve staggered six year terms and the chairperson is elected by the trustees each August for the following fiscal year.

The primary responsibilities of the board include appointing agency staff including the executive director, the deputy executive director, the internal auditor, the Investment Advisory Committee, and the consulting actuaries. In addition, the board sets policy and adopts rules pertaining to the investment of funds and the administration of benefit programs. The trustees are ultimately responsible for the financial well-being of the system and as a result, are considered fiduciaries for legal purposes. This means the members of the board, along with the executive director and various other administrative personnel, are personally responsible for the financial soundness of the retirement system. They are required by the state constitution to administer the system in accordance with the "prudent person rule". This is a standard of behavior which requires the fiduciaries of the system to administer the funds, investments and

benefits with the care and knowledge of a prudent person. The board also has the responsibility of deciding appeals resulting from decisions made by the ERS staff regarding the UGIP and the retirement programs. Any action after the board decision must be made through the court system.

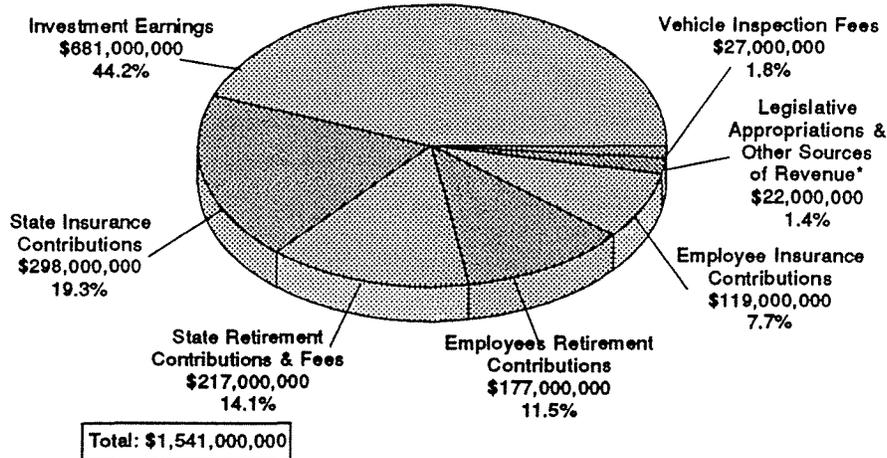
## FUNDING AND ORGANIZATION

The ERS is funded through investment earnings and employee and state contributions. The Texas Constitution mandates a specific range of percentages for contributions. Employees must contribute at least six percent of their monthly salaries to the system and the state must contribute from six percent to 10 percent of employee payroll to the system. The state contribution is set by the legislature for each biennium based on the needs of the system to maintain financial soundness. Currently, employees contribute six percent of salary and the state contributes another amount equal to 6.43 percent of employee salary. In fiscal year 1991, the state provided a total of about \$217 million in retirement contributions to the system.

In addition, the statute mandates that certain actions such as reducing the state or member contribution rates or establishing a new monetary benefit cannot be implemented if these acts cause the systems funding period to exceed 31 years. The system's funding period refers to the time needed for the ERS to pay its future liabilities. Currently, the ERS funding period is 2.1 years for the employees retirement fund and 3.4 years for the Judicial Retirement System - Plan Two. The Law Enforcement and Custodial Officers Supplemental Retirement Fund does not currently have a funding period because it has sufficient funds to meet future liabilities.

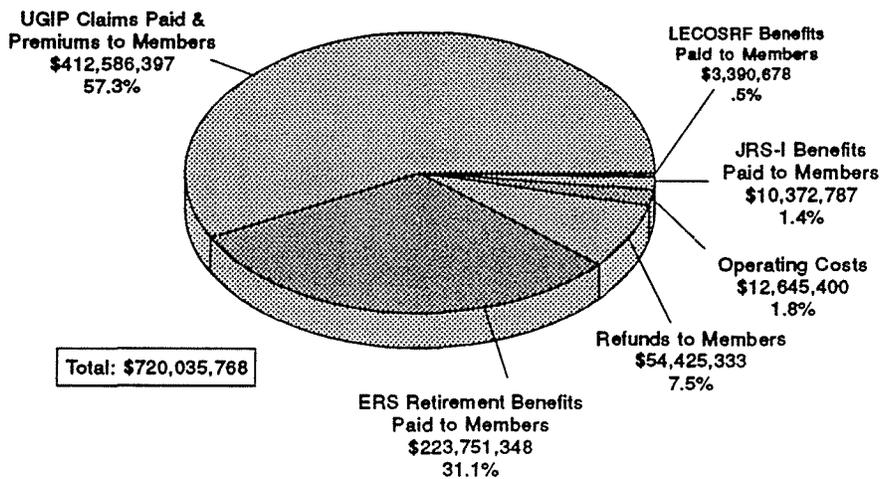
The largest revenue source for the system is interest and dividends made from the investing of the contributions received. In fiscal year 1991, the system earned about \$681 million through its investment activities which earned a rate of return of 10.06 percent based on \$7.9 billion of assets. In fiscal year 1991, the system received about \$177 million in employee contributions and about \$217 million in state contributions. Other sources of agency revenue include: state insurance contributions, employee insurance contributions, flexible benefits fees, rental income, legislative appropriations, retirement systems membership fees, vehicle inspection fees, and other sources of revenue. Exhibit A shows the percentage of total revenue and amounts each of these categories provided to the system. Exhibit B shows total agency expenditures including retirement and disability benefits and health insurance benefits for fiscal year 1991. Exhibit C shows the percentage of operating expenditures and amounts the various divisions of the agency accounted for in fiscal year 1991. Operating expenditures totaled about \$12.6 million for the system in fiscal year 1991. Exhibit D shows agency operating expenditures from fiscal year 1987 to fiscal year 1991. Detailed descriptions of each program's expenditures are made in the Programs and Functions section of this background.

**Exhibit A**  
**SOURCES OF REVENUE**  
Employees Retirement System  
FY 1991

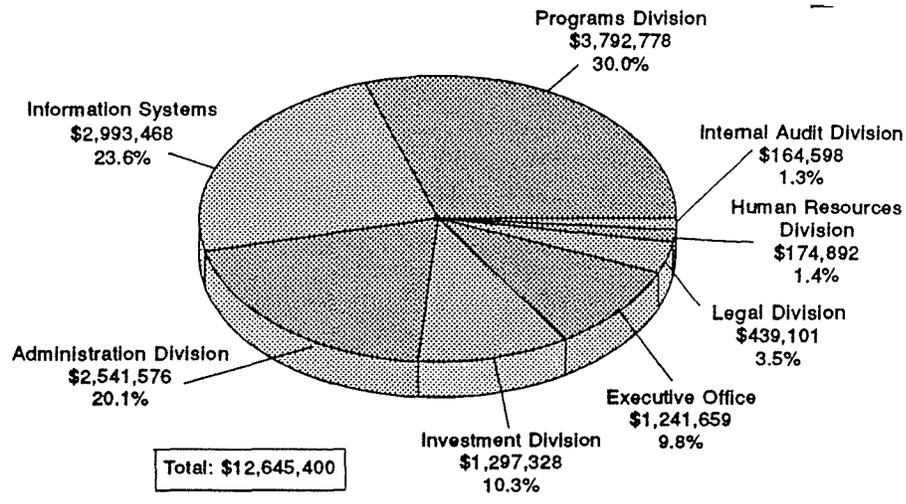


\*Includes appropriations for JRS-I, death benefits for commissioned peace officers, and membership fees.

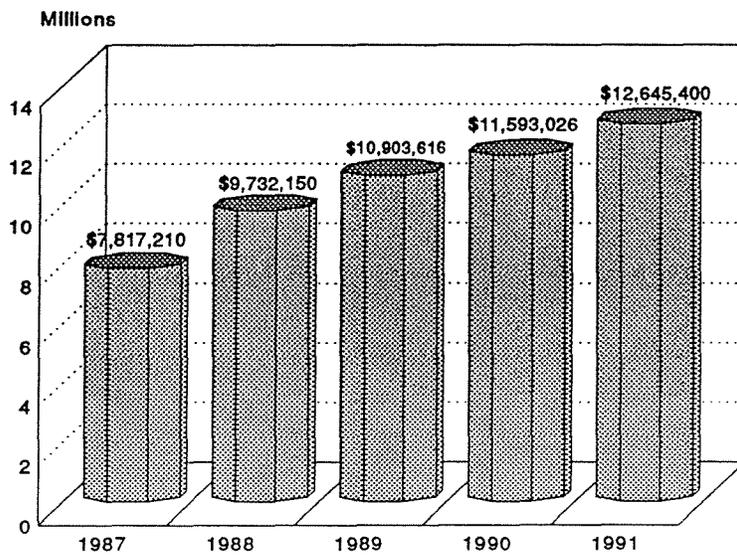
**Exhibit B**  
**EXPENDITURES BY ACTIVITY**  
Employees Retirement System  
FY 1991



**Exhibit C**  
**OPERATING EXPENDITURES BY DIVISION**  
 Employees Retirement System  
 FY 1991



**Exhibit D**  
**HISTORY OF ADMINISTRATIVE EXPENDITURES**  
 Employees Retirement System  
 FY 1987-1991

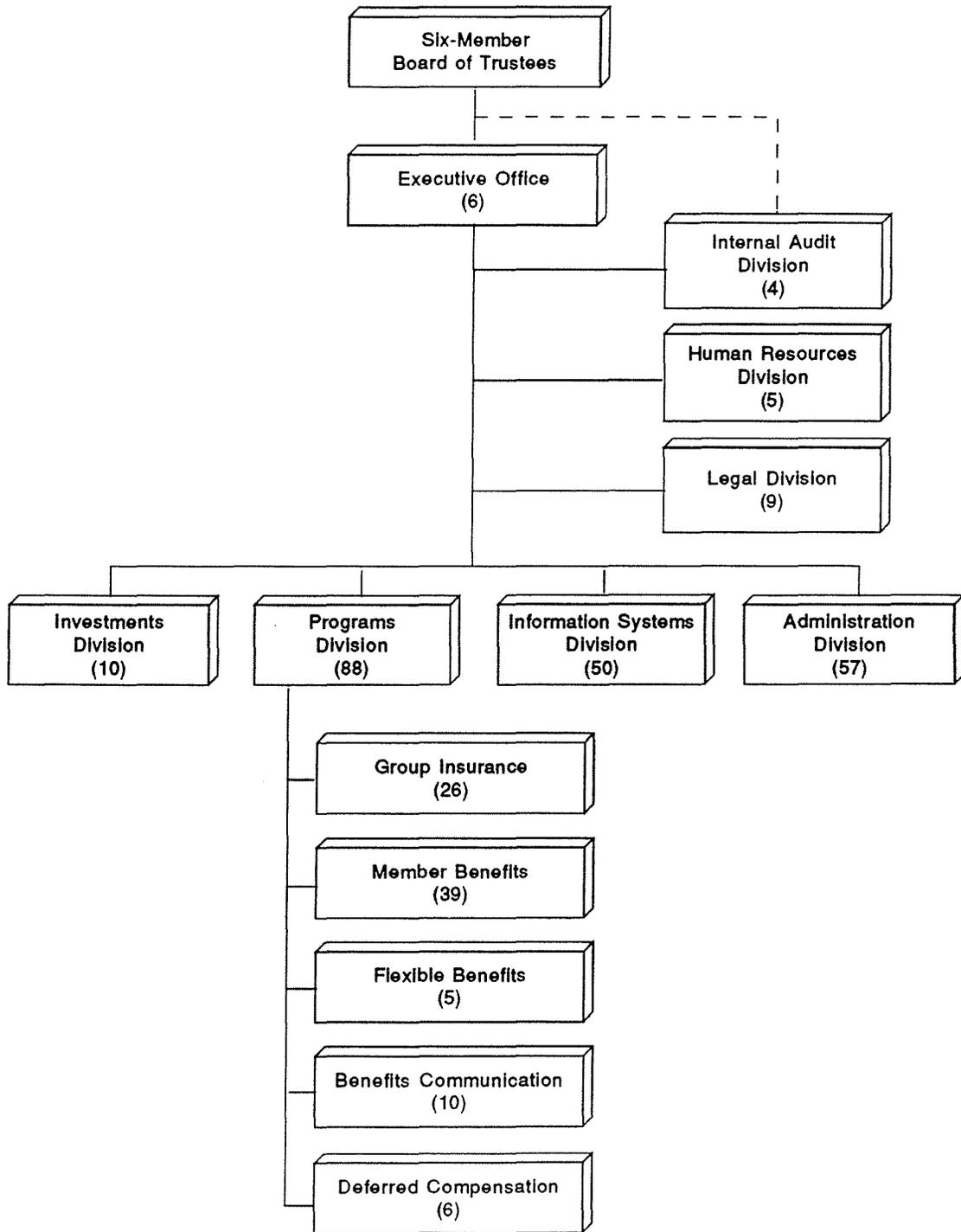


In fiscal year 1991, the system employed 229 full-time employees to administer the variety of benefit programs offered by the state. The system does not maintain any field offices and houses all of its operations at its headquarters in Austin. In general, about 60 percent of the staff are involved in administration of ERS retirement activities, while about 40 percent are involved in insurance and other employee benefit activities. Exhibit E depicts how the agency's work force has changed over a five-year period in different categories of employment and how it compares with minority work force goals set in the Appropriations Act. Exhibit F shows the organizational structure of the system.

**Exhibit E**  
**PERCENTAGE OF MINORITIES IN AGENCY'S WORK FORCE**  
 Employees Retirement System

Job Category	1988 Total Work Force 198		1991 Total Work Force 229		1992-1993 Appropriations Act Statewide Goal for Minority Work Force Representation
	Total Positions	% Minority	Total Positions	% Minority	
Administrators	1	0.0%	7	14.3%	14%
Professionals	107	13.1%	115	13.9%	18%
Technicians	8	37.5%	12	50.0%	23%
Protective Service	N/A	N/A	N/A	N/A	48%
Para-Professionals	27	22.2%	41	29.3%	25%
Administrative Support	50	46.0%	50	48.0%	25%
Skilled Craft	5	80.0%	3	66.7%	29%
Service/Maintenance	N/A	N/A	1	100.0%	52%

**Exhibit F**  
**ORGANIZATIONAL CHART**  
Employees Retirement System  
August 31, 1991



*Total Full-Time Equivalent Employees: 229*

As seen in Exhibit F, the system administers five programs dealing directly with employee and retiree benefits. These are: the UGIP, Member Benefits Program, the Flexible Benefits Program, the Benefits Communications Program, and the Deferred Compensation Program. The system runs another seven divisions which are designed to offer support services to the benefits programs. These are: the Investment Division, the Information Systems Division, the Administration Division, the Human Resources Division, the Legal Division, the Internal Audit Division, and the Executive Office Division.

## PROGRAMS AND FUNCTIONS

The system's mission is to enhance the economic well-being of members, retirees, and their beneficiaries through effective management of benefit programs based on sound actuarial principles and available resources. To this end the system administers a variety of programs. This section will discuss the system's major programs as well as its investment function.

### Retirement Programs

The ERS is responsible for administering four retirement programs. Each of these programs is for a specific group of state employees or officials. The Member Benefits division, which administers these programs has 39 employees and expended \$1.4 million in FY 1991. It is responsible for ensuring that every employee and retiree receives the correct amount of benefits and maintains records to ensure this.

### ERS Retirement Program for Elected and Employee Class Members (ERS)

All full-time and part-time state employees are required to be contributing members of the ERS. Coverage for state elected officials is optional. Within the ERS are two classes of membership: the elected class and the employee class. Membership in the elected class is limited to persons who hold state office that are normally filled by election but excludes officials covered by the JRS-I and JRS-II programs (discussed below). Membership in the employee class includes employees and appointed officers of the state. Membership begins on the first day of employment or office and continues until retirement or withdrawal from state service. While a member of the ERS, employees contribute six percent of their monthly salary to their retirement fund which is currently matched by a 6.43 percent contribution by the state. Legislators contribute eight percent of their salary to the retirement fund.

After five years of creditable service, a member becomes vested in the system. This means that after five years of service the member becomes eligible for a monthly payment from the system upon retirement. If an employee has five years of service at age 60, 25 years of service at age 55, or 30 years of service at age 50, he or she can qualify for full retirement benefits. Retirees with 10 or more years of service also receive continued health insurance coverage. Elected officials can qualify for retirement payments and continued health insurance coverage with eight years of service at age 60 or 12 years of service at age 50. The monthly retirement

payment for the employee group is two percent of the annual average of their highest 36 months of salary for each year of creditable service. For example, a 30-year employee whose highest 36-month salary averaged \$40,000 would receive two percent for each of those 30 years. That amounts to 60 percent of the \$40,000, or, \$24,000. The monthly retirement payment for elected officials is two percent for each year of creditable service times the active monthly salary of a state district judge, that is, \$6,894.58. For example an elected official with 10 years of service would earn 20 percent of \$6,894.58 or \$1,378.92 per month. No state employee or official can receive more than 100 percent of his average salary as a retirement payment.

As can be seen from the above, the amount of retirement payments and benefits a person receives is contingent on the amount of time they remain in state service. A state employee or official earns creditable service in the system for each month that a contribution is deducted from his or her paycheck. However, an employee or official can purchase additional credit for active military service so long as they have an honorable discharge and do not qualify for a military retirement. Upon retirement, unused sick leave can be converted to creditable service at the rate of one additional month of credit per forty days of sick leave. If an employee or official has also accrued credit in another retirement system, such as the Teachers' Retirement System or either of the Judicial Retirement Systems, then the Proportionate Retirement Program can be used to combine years of service credit to allow the employee or official to retire from more than one system, providing that the combined length of service satisfies the minimum requirement for the systems from which the person will be receiving retirement benefits.

Any state employee or official can qualify for a disability retirement if they become mentally or physically unable to work and the disability is likely to be permanent. There are two types of disability retirement: occupational and non-occupational. Regardless of age or length of service, a state employee or official is eligible for occupational disability retirement if it can be proven that the disability was the direct result of a risk or hazard inherent to the employee's or official's job. To qualify for occupational retirement, a medical examination is required and the system's medical board must certify the disability. If a person qualifies for occupational disability retirement, they will receive the standard retirement payment or may select an optional plan for his years of service and salary level. However, there is a minimum payment level of 35 percent of their monthly salary at the time of injury or \$150 per month, whichever is greater.

To be eligible for non-occupational disability retirement a state employee or official must be disabled and have 10 or more years of creditable service. If an employee or official qualifies for non-occupational disability retirement, then he receives the standard retirement payment or may select an optional plan with a minimum of at least 20 percent of his final average salary or \$150 per month, whichever is greater.

The standard retirement program also provides death benefits. If an employee or official dies as a result of a job-related illness or injury, a lump sum payment of one year's salary is paid to the surviving spouse or dependent minor children. This is in addition to any other benefits which may accrue to the survivors. If a state official or employee is retired at the time of death,

a lump sum payment of \$5,000 is paid to a designated beneficiary in addition to any other survivor benefits.

There were 142,771 individual retirement accounts in the ERS program at the close of fiscal year 1991. Of these, 131,175 were accounts of active contributing members and 11,596 were accounts of non-contributing members. In addition, there were 26,353 retirees receiving payments at that time. During that fiscal year, 17,914 refunds were made to former employees who withdrew their funds and thereby canceled credit in the system. Death refunds for the same period totaled 235. Over the same time period, 1,365 members began receiving service retirement payments. Since the system was established in 1947, 38,011 members have applied for and received retirement benefits. Of these, 35,184 received service retirement payments and 2,827 received disability retirement payments. As of August 31, 1991, there was about \$6.9 billion in the ERS fund. In fiscal year 1991, \$223 million in payments were made to retirees.

#### Law Enforcement/Custodial Officer Supplemental Retirement Fund Program (LECOSRF)

This fund offers supplemental retirement benefits, in addition to those offered to other state employees, to custodial officers employed by the Texas Department of Criminal Justice and certified by that department as having a normal job assignment that requires regularly planned contact with inmates. The fund also covers commissioned law enforcement officers of the Texas Department of Public Safety, the Texas Alcoholic Beverage Commission, and the Texas Parks and Wildlife Department. The supplemental benefit provided to these officers is an additional percentage of the highest 36 months salary added directly on top of their normal retirement payment. This supplement is funded by a portion of the state vehicle inspection fee. Vesting, retirement applications, disability retirement, death benefits and special service credit are the same as under the employees retirement plan. However, eligible officers can retire at any age with 20 years of service rather than age 50 for other state workers. At the close of fiscal year 1991, there were 1,190 people receiving supplemental benefits under this program. As of August 31, 1991, there was about \$268 million in the LECOSRF.

#### Judicial Retirement System Program - Plan One (JRS-I)

This program offers retirement benefits to state judges and justices of the supreme court, the court of criminal appeals, the court of appeals, district courts and certain other court officers, who became members of JRS prior to August 31, 1985. All judges first elected after this date are members of JRS-II and are excluded from JRS-I. Under JRS-I, members make a six percent contribution and the state makes a biennial appropriation. In fiscal year 1991, the legislature appropriated \$10.5 million to this fund. Members of this program can choose the same payment options, and are eligible to file a death benefit plan, the same as members of the regular retirement plan. As of August 31, 1991, there were 362 retirement accounts in JRS-I. Of those, 331 accounts were of active members and 31 were of non-active members, which are members who no longer work for the state but keep their money in the program. As of the same date, 321 retirement payments were being made.

### Judicial Retirement System Program - Plan Two (JRS-II)

This program offers retirement benefits to state judges and commissioners of the supreme court, the court of criminal appeals, the court of appeals, district courts and certain other court officers who first became members after August 31, 1985. Under the JRS-II statute, members contribute six percent of their monthly pay, which is matched by the state's contribution of 9.39 percent. Members of JRS-I are excluded from this plan. The system also provides service retirement, death and disability benefits. As of August 31, 1991, there were 184 active contributing members and seven non-contributing members in JRS-II. As of the same date, no retirements by plan participants had occurred and therefore no retirement payments were being made. As of August 31, 1991, there was about \$6.5 million in the JRS-II fund.

### Investments

The previous retirement programs and the mission of the agency depend heavily on the investment program. The agency's mission is to enhance the economic well-being of members, retirees, and their beneficiaries through management of benefit programs based on sound actuarial principles and available resources. Consistent with this mission, the goal of the investment program is to preserve the various funds and accumulate investment earnings for future benefit needs through a sound investment program.

The board of trustees is the trustee of the system's assets, valued at \$7.9 billion in fiscal year 1991. The board is also responsible for the administration and investment of all assets of the system. As a result, the board sets all investment policy. The board is advised on investment policy by the staff and has chosen to establish an Investment Advisory Committee to provide expert advice. The Investment Advisory Committee is composed of at least five but not more than nine members. The members are selected by the board of trustees for staggered three-year terms. The members are selected from the private sector and universities on a willingness-to-serve basis. They must have experience in the management of a financial institution or other business in which investment decisions are made, or as a prominent educator in the fields of economics or finance. The committee meets quarterly and reviews the previous quarter's investment transactions, investment performance, the approved list of stocks, minimum quality standards set for securities and the overall investment policy of the system. Together with the outside investment advisors and the staff, they recommend to the trustees the system's asset mix and portfolio strategy. Members of the committee are paid \$400 per meeting.

As mentioned above, the system also retains professional outside investment advisors to assist and advise the staff, the Investment Advisory Committee, and the board in setting investment policy. Advisors also make recommendations related to potential stock transactions. Advisors are selected on the basis of experience, past investment results and the ability to provide competent economic and investment advice consistent with the investment philosophy and goals of the board of trustees. In fiscal year 1991, the agency expended \$432,038 on external advisors.

Once the investment policy has been determined and approved by the board it must be implemented on a day-to-day basis. Trading of portfolio assets usually begins with a recommendation from one of the external advisors on particular stocks which appear to be worthy of acquisition or sale by the system. The investment staff then make an evaluation of the external advisor's recommendation. Before purchase or sale of the stock can be made, the executive director must give final approval. Once approval is received, the system's traders are allowed to purchase or sell the stock.

To help achieve the system's investment goals, the board, with advice from the Investment Advisory Committee, has established several investment policy guidelines. These guidelines deal with permissible investments, diversification, and quality of investment restrictions. As of August 31, 1991, 70 percent of the system's assets was invested in bonds and 30 percent was invested in stocks. There are no statutory or other limitations on investments the system can make other than the prudent person rule. The one exception relates to the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOSRF). The money in this fund is only allowed to be invested in fixed income investments. The ERS also makes use of diversification guidelines to prevent the assets from becoming overly exposed to the fortunes of too few companies. The guidelines help to insulate the system from poorly performing stocks. The system has also established guidelines dealing with the grade of corporate bonds in which the system can invest. To be eligible for purchase by the system, corporate bonds must have a rating of "A-" or the equivalent, or a better rating by the Moody's or Standard and Poor's rating services.

Overall, investment performance is evaluated on the basis of meeting or exceeding the investment goals established by the board. The investment performance is also compared to the market as a whole by making use of the rolling five-year average rate of return and comparing it to a market composite of nationally recognized indices, such as the Standard and Poor's 500 Index for stocks to determine how successful the agency was, compared to the market in general. As of the end of fiscal year 1991, the five year rolling rate of return for the system was 10.46 percent while the composite index's five-year rolling rate of return was 10.17 percent.

In fiscal year 1991, the Investment Division employed 10 full-time employees and expended about \$1.3 million. These costs represent about .03 percent of the overall earnings of the investment portfolio market value as of July 31, 1992.

### **Texas Employees Uniform Group Insurance Program (UGIP)**

In 1976, the state began offering health insurance coverage under the UGIP to state employees, elected officials, judges, retirees and their eligible dependents. The plan offers its members a comprehensive medical care plan, term life insurance, long-term and short-term disability income insurance, accidental death and dismemberment insurance, dental insurance, and for eligible participants, a choice of health maintenance organizations (HMOs). The board is assisted in the development of these programs by the Employee Benefits Advisory Committee. The committee is established by statute and is composed of 25 elected and appointed members

representing state agencies, higher education institutions and retirees. The committee is charged with making recommendations to the board concerning members' insurance needs and the system's options to meet those needs.

When a person is hired by the a state agency or certain state colleges or universities, or becomes an elected official of the state, he or she becomes eligible to join the UGIP. The employee is automatically enrolled in the state's managed care plan, HealthSelect of Texas, unless that person is eligible for, and chooses one of 17 HMOs located across the state. HealthSelect is a managed care plan administered by Blue Cross and Blue Shield of Texas, Inc. (BCBS). A managed care plan is a health care plan that reduces costs by contracting with a network of physicians, hospitals and pharmacies for goods and services. However, because HealthSelect is a self-insured plan, all costs and risks are assumed by the state. The participants are free to choose their health service provider but receive incentives to use network providers. For example, members can choose any doctor they desire, but in order to pay the least out-of-pocket expense, they must choose a physician within the established network. If a member chooses a non-network doctor, the member incurs greater out-of-pocket expenses. A health maintenance organization is a more extensive form of health care management under which the participant *must* choose a service provider who is part of the established HMO network to receive any benefits. Unless an emergency situation exists, no reimbursement is made to the member if a non-HMO health care provider is used. The members generally pay a \$5-\$15 co-payment for a physician's office visit. In choosing between HealthSelect and an HMO, members should consider factors, such as limitations on their choice of physician, eligible claims, and out-of-pocket expense. As of August 31, 1992, 188,030 members and their dependents were enrolled in BC/BS, and 128,000 members and their dependents were enrolled in HMOs.

As mentioned above, the state has contracted with BCBS to administer the HealthSelect plan for ERS, effective September 1, 1992. As a result, BCBS provides staff, equipment and other resources necessary to administer HealthSelect in accordance with the policies and procedures of the ERS. For example, BCBS establishes the HealthSelect physicians network and receives and pays all claims. BCBS is then reimbursed by the ERS on a periodic basis.

Employee costs to participate in the UGIP vary with the type of coverage selected by the member. There are four levels of coverage available to employees. The first level of coverage is for the employee only. For participants in HealthSelect, this cost is paid entirely by the state. The second level of coverage is for the employee and his or her children. For HealthSelect participants, this coverage requires a monthly premium from the member of \$67.91. The third level of coverage is for the employee and spouse and it requires a monthly premium from the employee of \$101.42. The last level of coverage is for the employee and his or her family, which requires a monthly premium from the employee of \$169.32. Costs to employees participating in HMOs may be slightly higher or lower than HealthSelect. In fiscal year 1991, the state made contributions totaling about \$298 million and employees made contributions totaling about \$119 million to the Uniform Group Insurance Fund.

The Group Insurance Division monitors BC\BS compliance with the ERS contract and serves as the agency liaison between the ERS and BC\BS. In addition, the Group Insurance Division handles all reimbursement due to BC\BS as a result of BC\BS fulfilling the contract. Also, the division staff monitor and process complaints and grievances. In fiscal year 1991, the Group Insurance Division had a staff of 26 and expended about \$1.3 million.

### UGIP Appeals

If a member is denied services or reimbursement for services from BC\BS, he or she has the right to appeal that decision. The process begins with a letter from BC\BS insurance denying benefits to a member. The member may then appeal to the ERS within 90 days, where the case is heard by the grievance committee. The grievance committee is made up of the director and assistant director of group insurance, a registered nurse, members of the group insurance staff and an ERS attorney. If the committee upholds the BC\BS decision, the member may appeal that decision within 30 days. If this is done, the case is sent to the State Office of Administrative Hearings (SOAH) for a formal hearing. After the SOAH holds a hearing, a proposal for decision is sent to all the parties involved. All parties may file objections to the proposal, which are then presented to the board of trustees. The board makes the final decision whether to uphold or overturn the proposal. If the board denies benefits, the member may appeal the decision to the Travis County District Court.

### TexFlex

TexFlex is the state's flexible benefits program, also known as a "cafeteria plan." It consists of three plans, each of which allows employees to pay for specific benefits with pre-tax dollars, which reduces their taxable wages before federal income taxes are calculated. These plans are premium conversion, health care, and dependent care reimbursement accounts. Premium conversion allows employees to pay their UGIP premiums with tax-free dollars. The health care reimbursement plan allows employees to pay for health care costs not covered by their insurance plan, such as deductibles and co-payments with tax-free dollars. The dependent care reimbursement account allows employees to pay for dependent care expenses, with pre-tax dollars, if the care is necessary for the employee and, if married, the spouse to continue working. In addition, if the employee fails to use all the money in the account by the end of the fiscal year, that money is forfeited and used to cover the administrative costs of the program. In fiscal year 1991, 47,722 members participated in premium conversion, 4,356 participated in health care reimbursement, and 1,329 participated in dependent care reimbursement. The program employs five people and expended \$178,892 in fiscal year 1991.

### Deferred Compensation

The Deferred Compensation Program includes two state benefit plans created by IRS Codes 457 and 401(k). Both of these voluntary retirement plans can supplement Social Security and employee benefits received through the ERS retirement programs discussed above. These plans allow participants to reduce their pre-tax income by deferring a portion of their paycheck into

an approved investment. In the 457 Plan, employees can defer no more than \$7,500 or 25 percent of their gross income, whichever is less. Employees may choose from approved vendors and approved products in which the money can be invested. There are 229 approved products which include fixed and variable annuities, life insurance, mutual funds, money market accounts, certificates of deposit, and passbook savings accounts. Investments can be moved and/or changed by the participant to different approved vendors and/or products in the plan at the participant's convenience. The money in the 457 Plan can only be removed from the plan when the participant leaves state employment, dies, reaches age 70.5 or qualifies for an emergency withdrawal. The money in the plan is technically the property of the State of Texas and as a result the employee cannot use the funds in the plan for a loan.

The second deferred compensation plan offered to ERS members is Texa\$aver. Texa\$aver is a 401(k) plan, named for the portion of the IRS code that authorized such plans. Unlike Plan 457, the ERS has contracted with the Holden Group to provide enrollment services, accounting, disbursements, and account statements. The maximum annual contribution to Texa\$aver is 20 percent of total income or \$8,475, whichever is less. The amount is indexed annually by the IRS. Participants in Texa\$aver have two basic options in which to invest their money. Both options have a \$12 annual fee charged to participants. The first option allows investment in either a money market fund or stock fund and currently charges participants an enrollment fee of 2.5 percent of their monthly contribution. This option also charges participants an annual administrative fee of .5 percent of account assets. The second option allows participants to choose from one of four guaranteed interest options, a money market series, a bond series, a growth and income series, or a T. Rowe Price growth stock fund. There is a five percent surrender charge if money is withdrawn within six years of enrollment in the second option. Money invested in Texa\$aver can be withdrawn due to financial hardship, making a loan from the account, reaching age 59.5 or leaving state service.

The Deferred Compensation Division monitors the Holden Group and performs a monthly reconciliation of the Holden Group's reports. The division employed six people and expended \$178,057 in fiscal year 1991.

### **Administration**

In addition to the programs discussed above, the system also has several other programs designed to support the main mission of the agency. These are: the Information Systems Division, Benefits Communications Office, the Administration Division, the Human Resources Division, the Legal Division, the Executive Offices Division, and the Internal Audit Division.

The Information Systems Division provides the agency with computer services that are used to support all aspects of the ERS's operation. Key to this support is the strategic automation plan, which develops and anticipates the computer needs of each division within the ERS. The plan is revised every two years and is approved by the executive director. The Information Systems Division employed a staff of 50 and expended almost \$3 million in fiscal year 1991.

The Benefits Communications Office provides a point of contact with the agency for the members. The staff answers questions regarding benefits or account status but does not provide any legal or tax assistance. In fiscal year 1991, the office employed 10 persons and expended \$487,818.

The Administration Division is charged with performing a variety of housekeeping functions. This division administers accounting activities, property management, building maintenance, and supply and equipment purchasing for the system. The Administration Division employed 57 staff and expended over \$2.5 million in fiscal year 1991.

The Human Resources Division is responsible for five areas: employee training, benefits coordination for ERS employees, timekeeping, applicant tracking and EEO\affirmative action programs. The division employed five full-time employees and expended \$174,892 in fiscal year 1991.

The Legal Division is the responsibility of the general counsel, who reports directly to the executive director. The staff handle any legal questions raised regarding ERS program activities. This includes legislative bill reviews and analyses, bill drafting, administering qualified domestic relations orders, representing the system in appeals to the board or in court, as well as serving as the liaison to the attorney general's office. The division employed nine full-time staff and expended \$439,101 in fiscal year 1991.

The Executive Office Division ensures the quality of the "product" provided to the members. This is done through weekly meetings with department heads and reviewing internal audit reports. The Executive Office Division is responsible for developing the agency's six-year strategic plan. During the 72nd Regular Session, the legislature passed legislation requiring most state agencies to develop a six-year strategic plan. The strategic plans are the first step in building a long-term statewide budgeting and planning process. The agency has submitted its plan to the governor, lieutenant governor, speaker of the house of representatives and several legislative oversight agencies, including the Sunset Advisory Commission. In addition, this division reviews annual reports presented by Blue Cross and Blue Shield of Texas, Inc. on subjects such as cost containment. In fiscal year 1991, this division employed six full-time employees and expended over \$1.2 million.

The internal auditor is responsible for conducting independent reviews and evaluations of agency activities and furnishing the agency with appraisals, recommendations and information on activities reviewed. The Employees Retirement System complies with the state's Internal Audit Act and the internal audit function complies with the requirements of the act. The Internal Auditor reports directly to the Board of Trustees and the executive director. The system is divided into 31 auditable units and each is ranked, according to its potential to cause a disfunction in the system, into one of three categories: high, medium, or low risk. High risk units are reviewed every year, medium risk units every other year, and low risk units every third year. In fiscal year 1991, the division had four full-time employees and expended \$164,598.



**TEACHER RETIREMENT SYSTEM OF TEXAS**



## CREATION AND POWERS

The Teacher Retirement System of Texas (TRS) was authorized in 1936 by an amendment to the Texas Constitution with enabling legislation signed into law in 1937 by the 45th Legislature. The TRS was created to provide a service retirement program for teachers and administrators of the public school systems of Texas, including the Texas Education Agency and institutions of higher education. Initially, the TRS served about 38,000 members. Membership was expanded in 1949 to include all employees of public education institutions including cafeteria workers and bus drivers. Currently, the TRS serves over 550,000 active members and 119,000 retirees and is the seventh largest public pension system in the United States.

The basic function of the TRS in providing a retirement program for public education employees has not changed significantly since its inception in 1937. One exception was the addition of the administration of a health insurance program for the TRS retirees in 1985. This program was established by the 69th Legislature because it was determined that most school districts do not extend health insurance coverage upon an employee's retirement. The Texas Public School Retired Employees Group Insurance Program, or TRS-Care, currently provides health insurance coverage to about 87,000 TRS retirees and their dependents.

One other major change came about in 1967 when the legislature established an Optional Retirement Program (ORP), separate and apart from the TRS. The ORP was designed to offer public college faculty members who frequently move out of state prior to vesting the opportunity to create their own more portable retirement programs through individual annuities. This program is overseen by the Higher Education Coordinating Board and administered by individual colleges and universities.

While the functions of the agency have not changed significantly, there have been a number of improvements in benefits over the years. The formulas used for calculating benefits have greatly improved the level of benefits a retiree can receive. Originally, retirement benefits were based on the member's average salary over all the years worked. In 1963 that was changed to key off the member's highest ten-year average salary, in 1971 it was reduced to the best five-year average salary, and currently it is based on the highest three-year average salary. The number of years required for a member to be vested for service retirement benefits upon reaching retirement age has gone from 25 to five years. In addition, the minimum age for standard retirement has been reduced from 60 to 55 years of age, if a member has 30 years of service.

There have also been a number of changes in the agency's investment authority. In general, the TRS is charged with making prudent investments in securities. The original constitutional amendment approved by the voters in 1936 only authorized the investment of system funds in government and municipal bonds. In 1956 this was expanded to permit investing of funds in corporate bonds and common stocks. Currently, the board invests in a mix of assets with a target of 49 percent in equities, 38 percent in fixed income securities, 10 percent in real estate, two percent in cash reserves, and one percent in alternative assets.

With these changes, the TRS's current responsibilities include providing retirement, disability, and death and survivor benefits to employees of public education in Texas, as well as

health insurance to eligible TRS public school retirees and their dependents. A primary focus of the agency in administering these programs is to invest its assets prudently and successfully to secure sufficient funds to finance benefits to participants upon their retirement or death.

## POLICYMAKING BODY

The Teacher Retirement System is overseen by a nine-member part-time board of trustees. Three of the members are direct appointees of the governor, two of which must have demonstrated financial expertise and none of which may be active TRS members or retirees. The governor also selects two public school employees from a slate of three nominated by fellow public school employees; one retiree from a slate of three nominated by the TRS retirees; and one higher education employee from a slate of three nominated by employees of higher education. The State Board of Education appoints the remaining two members of the board. All appointments are subject to confirmation by two-thirds of the senate. The board elects a chair from among its members and meets at least quarterly.

Under the state constitution, the board is responsible for administering the system and investing the funds of the system. The constitution provides that the board operate according to the "prudent person rule." This means that the board must exercise the judgement and care that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, considering the probable income and safety of their capital. As trustees of the funds, board members have fiduciary duties. Pension trust assets must be held for the exclusive benefit of plan participants and beneficiaries. Trustees have a special responsibility for protecting the actuarial soundness of the system and they can be personally held accountable for violation of these duties.

The board designates an actuary as its technical adviser, appoints a medical board to review medical applications for disability retirement benefits, and appoints a group insurance advisory committee to assist the board in administering the health insurance program for TRS retirees. Other duties of the board include approving the annual operating budget for the retirement program and for the TRS-Care program and adopting rules related to membership, administration of the funds, and transaction of business.

The board is also responsible for appointing an executive secretary to run the agency on a day-to-day basis. The executive secretary, according to statute, recommends to the board actuarial and other services necessary to administer the system. Annually, the executive secretary prepares an itemized expense budget for the following fiscal year and submits the budget to the board for review and adoption. The executive secretary may not be a member of the board and must have been a citizen of the state for the three years immediately preceding the appointment.

## FUNDING AND ORGANIZATION

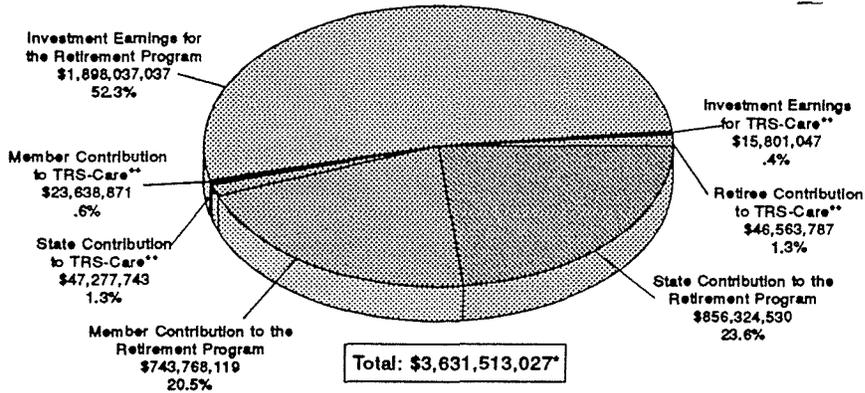
Funding for the retirement program and TRS-Care are provided by state and member contributions. The constitution mandates that the state contribution to the TRS may not be less

than six percent nor more than ten percent and the member contribution may not be less than six percent of current compensation. The legislature follows this mandate when setting the state and member contribution rates, and, in fiscal year 1991 the state contributed 7.31 percent to the retirement program and the active members contributed 6.4 percent. The state contribution rate to the retirement program was reduced by the 72nd Legislature from 7.65 percent to 7.31 percent for fiscal year 1991. Beginning September 1, 1993, the state contribution rate will automatically increase to 8 percent unless legislation is passed modifying this rate. According to statute, the legislature is prohibited from adjusting the state and member contribution rates or establishing a new benefit program if either of these two acts result in a TRS funding period of 31 years or more. The system's funding period refers to the time needed for TRS to pay off its future liabilities. Currently, the TRS funding period was 28 years, as of August 31, 1991. Although the TRS retirement program and the TRS-Care program are two separately funded entities, for the purpose of describing the sources of revenue and expenditure for the system as a whole, the two funds have been combined in the following description.

The TRS collected a total of \$3.6 billion in revenue in fiscal year 1991. The largest revenue source for the system was investment earnings. In fiscal year 1991, with an 8.56 percent total rate of return, investment earnings from the retirement program totalled \$1.9 billion or 52.3 percent of the total revenue and TRS-Care investment earnings totalled \$15.8 million or .4 percent of total revenue. At the end of fiscal year 1991, the total value of the TRS retirement fund was \$23.7 billion and the total value of TRS-Care was \$145 million. The second largest revenue source is contributions which accounted for 47 percent of total revenue. In fiscal year 1991, the state contributed a total of \$856 million to the retirement program and \$47 million to TRS-Care and members contributed \$744 million to the retirement program and \$23.6 million to TRS-Care. Of the \$744 million in member contributions to the retirement program, \$5 million includes an annual \$10 membership fee which provides about 20 percent of the system's administrative costs. Additionally, TRS-Care received \$46.6 million from retiree contributions for additional coverage. Exhibit A shows the sources of revenue for the entire Teacher Retirement System in fiscal year 1991.

The TRS expended a total of \$1.4 billion in fiscal year 1991. The largest expenditure was accounted for by the retirement benefits that were paid to members which totalled \$1.2 billion or 82.1 percent of total expenditures. The remaining 17.9 percent of the total expenditures was accounted for by \$134 million in refunds paid to members who terminated TRS-covered employment, \$95 million in insurance claims paid to TRS retirees under TRS-Care, \$22 million in operational expenses, and \$7.3 million in administrative costs paid to the TRS-Care insurance carrier. Exhibit B shows the agency's total expenditures and benefits and Exhibit C provides a breakdown of the operating costs by division for fiscal year 1991. Exhibit D shows the agency's total operating costs for the last five fiscal years.

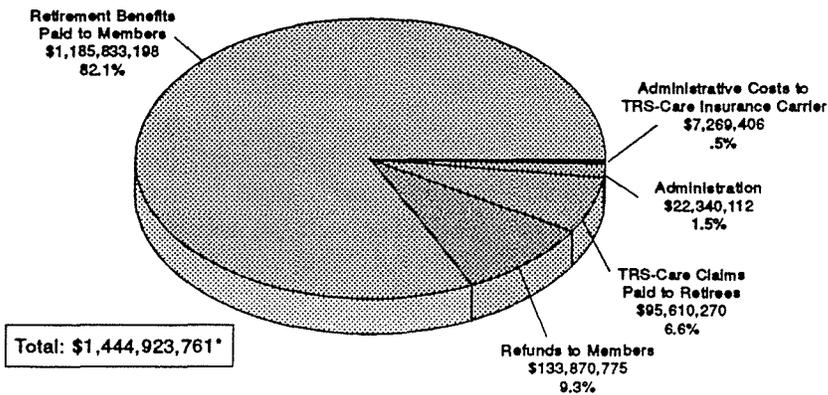
**Exhibit A  
SOURCES OF REVENUE  
Teacher Retirement System  
FY 1991**



\* An additional \$101,883, not shown here in detail, is collected by the retirement program from TRS-Care for various services such as rent and legal advice.

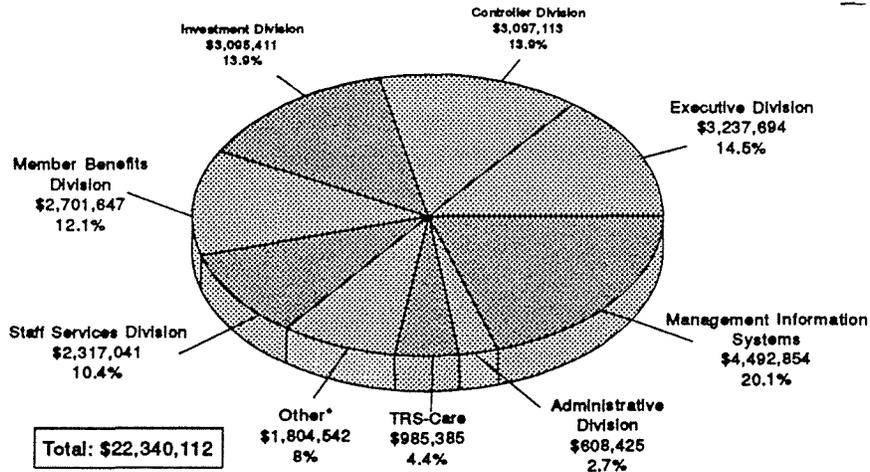
\*\* The TRS-Care is a separately funded program and TRS retirement trust funds cannot be used to support it.

**Exhibit B  
EXPENDITURES BY ACTIVITY  
Teacher Retirement System  
FY 1991**



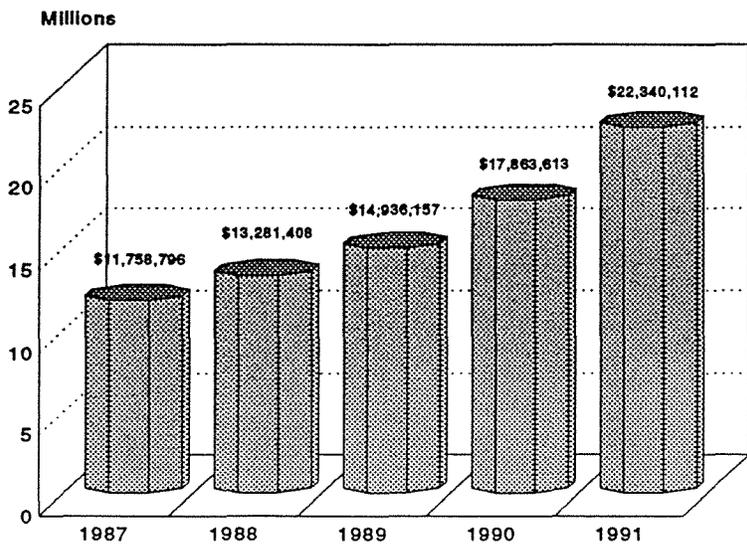
\*An additional \$2 billion, not shown here, is transferred to the Retired Reserve Account where it is reinvested to pay for future benefits.

**Exhibit C**  
**OPERATING EXPENDITURES**  
Teacher Retirement System  
FY 1991



*\*Workers and employment compensation, fiduciary liability insurance, health insurance for retired TRS employees, compensable absences and depreciation.*

**Exhibit D**  
**HISTORY OF OPERATING EXPENDITURES**  
Teacher Retirement System  
FY 1987 - 1991



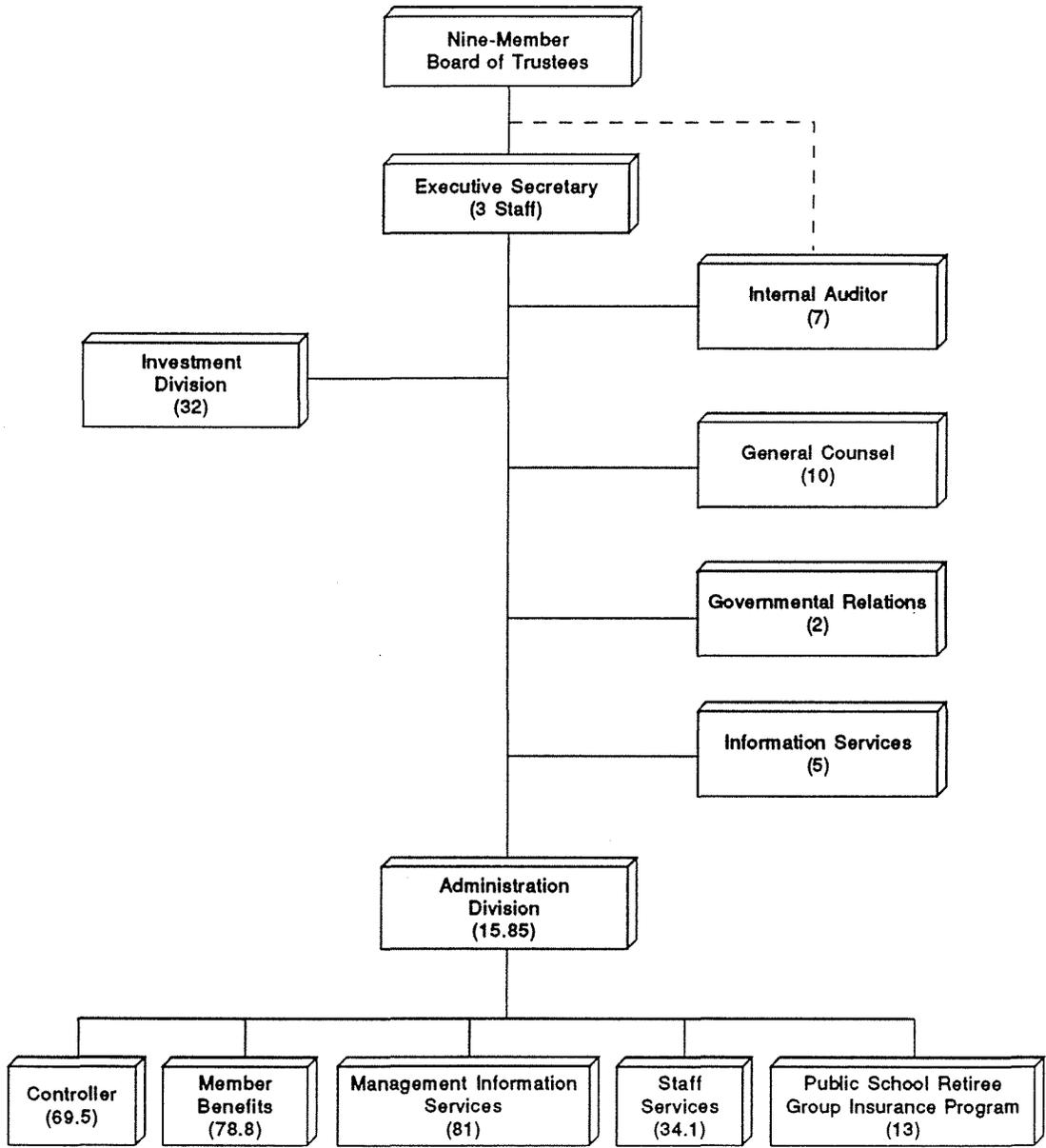
In fiscal year 1991, the Teacher Retirement System employed 352 employees. Of these, 96 percent worked with the Retirement Program and the remaining four percent worked with the TRS-Care program. The Teacher Retirement System is headquartered in Austin with no field offices. However, counseling sessions are held at various locations throughout the state for prospective retirees.

The TRS is divided into eight divisions: Executive, Investments, Administration, Controller, Member Benefits, Management Information Systems, Group Insurance, and Staff Services. Exhibit E shows how the ethnic composition of the agency's work force has changed over a four-year period. Exhibit F shows the organizational structure of the agency.

**Exhibit E**  
**PERCENTAGE OF MINORITIES IN AGENCY'S WORK FORCE**  
 Teacher Retirement System

Job Category	1988 Total Work Force 280		1991 Total Work Force 339		1992-1993 Appropriations Act Statewide Goal for Minority Work Force Representation
	Total Positions	% Minority	Total Positions	% Minority	
Administrators	50	4.0%	39	2.6%	14%
Professionals	122	21.3%	121	24.8%	18%
Technicians	15	20.0%	11	27.3%	23%
Protective Service	0	0	6	66.7%	48%
Para-Professionals	14	21.4%	86	23.3%	25%
Administrative Support	71	39.4%	66	45.5%	25%
Skilled Craft	3	100.0%	6	83.3%	29%
Service/Maintenance	5	100.0%	4	100.0%	52%

**Exhibit F**  
**ORGANIZATIONAL CHART**  
Teacher Retirement System  
August 31, 1991



Total Full-Time Equivalent Employees: 351.25

## PROGRAMS AND FUNCTIONS

The key functions of the TRS include providing a retirement program, investing the system's funds, overseeing a retiree health insurance program, and administration. Each of these functions are discussed in detail in the following sections. This report refers to two types of TRS members, active members and retirees. Active members are those who are employees of the public schools and institutions of higher education. Retirees are those members who have retired from the public schools and institutions of higher education.

### Retirement Program

The retirement program at the TRS is a defined benefit plan which means that specific retirement benefits, generally based on the member's final average salary for a certain number of years, are provided to the employee at the time of retirement. The program provides retirement, disability, and death and survivor benefits to employees of the public schools and public colleges and universities. These employees become members of the TRS retirement program automatically upon employment with the exception of eligible members who choose to join the Optional Retirement Program (ORP), which is described in detail later in this section.

As an active TRS member, 6.4 percent of one's salary is automatically withdrawn and contributed to the retirement system; however, aside from an annual report prepared for each member, little direct contact generally occurs with the system until a member nears retirement. The TRS receives monthly reports from the school districts regarding employee salary and any position changes. The TRS maintains these member records, updating them when necessary. The TRS also publishes a number of informational materials related to retirement for its members, including general information booklets, an annual TRS statement of account, and a quarterly TRS newsletter. In fiscal year 1991, there were 520,617 active TRS members employed in public schools, colleges, and universities throughout Texas.

The TRS members become vested in the system with five years of creditable service. This means that after five years of service with a school or university covered by the TRS, members qualify for full retirement benefits upon reaching retirement age. This is the case even though they may leave covered employment, provided they do not withdraw their deposits. TRS members may retire at what is called normal age retirement and receive full retirement benefits or at an earlier age and receive reduced benefits. At the TRS, normal age retirement is at age 65 with five or more years of service, at age 60 with twenty or more years, and at age 55 with thirty or more years of service. Those members who opt for early age retirement with reduced benefits may do so if they retire earlier than age 55 with thirty or more years of service or at age 55 with five or more years of service.

Annual retirement benefits are calculated under a statutory formula. This formula is currently two percent of the member's highest three-year average annual salary, multiplied by the member's total years of service.

When applying for retirement, a member chooses from one of five payment plans. The plans range from receiving the full monthly retirement benefit with benefits ceasing upon the death of the retiree, to receiving a reduced monthly benefit with payments continuing to the designated beneficiary for a specified period of time after the death of the retiree. In fiscal year 1991, there were 7,662 service retirements.

The Teacher Retirement System also provides disability benefits to its members. As approved by the 72nd Legislature, a member may apply for disability retirement upon meeting the eligibility requirements, regardless of age. A three-member medical board examines disability applications initially to certify disability and, at defined intervals, updates the status of the disability. According to statute, the executive secretary of the TRS is authorized to approve disability retirements after they have been approved by a majority of the medical board. Disability retirees can select benefit options similar to those of service retirees. For fiscal year 1991, there were 660 disability retirements.

Death and survivor benefits are paid to both active member and retiree beneficiaries. Upon the death of either an active member or retiree, the beneficiary will receive either benefits ranging from a lump sum payment to lifetime payments at a reduced monthly amount. In fiscal year 1991, there were 4,078 active member and retiree deaths.

The TRS also offers retirement service credit for work done outside TRS-covered employment. This benefit is referred to as special service credit. The two main types of special service credit are military duty and out-of-state employment with other public school systems. Members who have at least five years of credit for actual service in Texas public schools are eligible to purchase service credit for up to five years of military service. Members who have at least ten years of credit may purchase service credit for actual service in a public school system in another state.

As an alternative to the TRS retirement program, certain public college and university employees may choose the Optional Retirement Program (ORP) which is administered by the Higher Education Coordinating Board. The ORP was created by the legislature in 1967 to accommodate and attract more mobile college and university faculty members who would not be employed long enough to be vested in the standard TRS retirement program. Funding for the ORP is provided by state and active member contributions. In 1991, the legislature reduced the state contribution rate to the ORP from 8.5 to 7.31 percent to match the state contribution to the TRS. The employee contribution rate remained at 6.65 percent of employee salary, compared to the 6.4 percent for member contributions to the TRS. Colleges and universities may make payments to bring the state's contribution up to the previous 8.5 percent rate. The ORP is a defined contribution plan which means that upon retirement, the ORP member receives benefits based on the accumulated contributions and interest in that member's account. The ORP allows members to vest in one year and entitles them to their state and member contributions as well as investment earnings upon termination of their employment with the college or university. In fiscal year 1991, there were over 34,706 college and university employees participating in the Optional Retirement Program.

## Investments

The board of trustees is ultimately responsible for investing the assets of the Teacher Retirement System. The Texas Constitution provides that the board of trustees shall invest the funds of the system in such securities as the board may consider prudent investments. This mandate is referred to as the "prudent person" rule. The emphasis of the TRS investment policy is placed on potential long-term returns and diversification of the investments. The board of trustees has the authority, by statute, to contract with private professional investment managers to assist the board in investing the assets of the system.

The board fulfills its investment responsibilities with the help of an Investment Advisory Committee (IAC), internal investment staff, and outside professional counsel. By rule, the IAC is composed of from five to nine members who are investment specialists appointed by the board. The committee advises the investment staff and board on investment policy, planning, and evaluation of investments. The IAC also has a real estate finance committee that reviews and recommends potential real estate investments proposed by the staff. The TRS investment staff is responsible for the execution of all securities transactions and report to the board quarterly. The board also retains Wellington Management Company of Boston as outside investment counsel, four real estate advisors, and The Wyatt Company as its consulting actuary. The Investment Division of TRS employed 32 staff and expended about \$3.1 million in fiscal year 1991.

In compliance with the constitution and state law, the trustees invest the funds of the system in fixed income securities, real estate mortgages, and equities. The TRS has also chosen to participate in the Texas Growth Fund, which is a program promoting economic development in the state. In fiscal year 1991, 47 percent of the TRS funds were invested in equities, 44.8 percent in fixed income securities, and 8.2 percent in other investments. Investment income for the year equalled \$1.9 billion.

The success of TRS investments is measured in several ways. One key way is to measure their performance against a composite of market indices, such as the S&P 500 (for equities) and the Lehman Brothers Aggregate Bond index (for fixed income securities). For the five years ending September 30, 1991 the total TRS fund returned 12.0 percent per year, compared to the composite index rate of 12.3 percent per year. The book value of the TRS fund grew from \$21 billion in fiscal year 1990 to \$23.7 billion in fiscal year 1991.

## Retiree Health Insurance Program: TRS-Care

The Texas Public School Retired Employees Group Insurance Program (TRS-Care) was created in 1985 by the 69th Legislature. This program was established because the majority of public school districts, excluding higher education, do not offer health insurance coverage for retirees. TRS-Care provides for a basic level of catastrophic health insurance coverage at no cost for all eligible Texas public school retirees, regardless of where they reside. This program is funded from four sources: 1) a state contribution of 0.50 percent of salaries; 2) an employee

contribution of 0.25 percent of current salary; 3) contributions from participants for optional coverages; and 4) earnings on investments. The TRS-Care fund is a distinct trust fund separate from the TRS retirement trust fund. Federal and state laws restrict the use of pension funds for non-pension purposes. Therefore, TRS-Care rents office space in the TRS headquarters building and pays the TRS for legal, data processing, telephone, and other services provided by the system.

Through statute, the TRS board, as trustee for the program, appoints nine members to the Group Insurance Advisory Committee. The nine members include an active school administrator, a retired school administrator, two active teachers, three retired teachers, one active auxiliary employee, and one retired auxiliary employee. The advisory committee is required by statute to hold public hearings on group insurance benefits and recommend to the trustee minimum standards and features of the plan and desirable changes in rules and legislation affecting the program.

Retirees who are eligible to enroll in TRS-Care are former public school employees who have 10 years of credited TRS service and are not eligible to participate under the state employee or the higher education group insurance plans. Each eligible retiree is automatically enrolled in the plan unless they opt out. The plan offers basic catastrophic health insurance coverage at no cost to eligible retirees. Prescription drug benefits are available to all covered persons. Retirees covered by Part A of Medicare receive either higher benefits or lower costs in recognition of the additional coverage. If benefits beyond the basic level are chosen or if dependent coverage is selected, a monthly contribution is required of the participant. A more comprehensive benefit allowing retirees to order and receive a 90-day supply of maintenance drugs by mail for a fixed co-payment is available to those retirees and dependents enrolled in the most comprehensive level. In fiscal year 1991, there were 83,211 participants in TRS-Care.

The health insurance benefits offered through TRS-Care are provided by the Aetna Life Insurance Company. New contracts for health insurance coverage under this program must be submitted for competitive bidding at least every six years. The TRS pays Aetna for its costs of direct claims administration, cost of other administration, risk charges, and profit. Currently, the TRS holds all its reserve funds. The TRS has the option, by law, to self-fund the TRS-Care program. Self-funding allows the designated trustee to retain the contributions to the program, oversee the investment of the funds, manage the payment of claims, and eliminate insurer's risk charges. The TRS is evaluating this option but has not chosen to move in this direction as yet.

The TRS is also in the process of implementing a managed care network as a method of organizing, financing, and delivering health care services to its retirees at a minimized cost. The first phase will become effective September 1, 1992, with the implementation of a retail prescription drug network. The second and third phase include the implementation of a hospital network in September 1993 and a physician network in September 1994. TRS-Care employed 13 staff and expended less than \$1 million in administrative expenses in fiscal year 1991.

## Administration

The TRS is headed by the executive secretary who is appointed by the board. The executive secretary is assisted by a number of people within the executive division, as well as by the administrative division. Both of these divisions are described below.

### Executive Division

The executive division is headed by the executive secretary who is appointed by the board of trustees. The main responsibility of the executive secretary is to ensure that the agency operates in accordance with state and federal laws and with policies approved by the board. Other duties of the executive secretary include formulating and implementing long and short-term goals and objectives and plans for achieving them, consulting with advisory groups, formulating and recommending to the board long-term investment policies and objectives, preparing the annual operating budget for both the retirement and group health insurance programs for board approval, and reporting regularly to the board on all matters affecting the agency. In addition to the executive secretary, the executive division consists of governmental relations, internal audit, general counsel, and information services. The executive division operated with a staff of 27 and expended about \$3.2 million in fiscal year 1991.

### Governmental Relations

The main responsibilities of the governmental relations office include responding to requests from members of the Texas Legislature and U.S. Congress, coordinating all liaison activities with state and federal agencies, and providing the TRS staff and members with information on the status of state and federal legislation which might impact the Teacher Retirement System. This office also responds to frequent requests of updates on legislative issues from active members and retirees through an 800 number center. The toll-free telephone line received nearly 25,000 phone requests during the 72nd regular and called legislative sessions.

### Internal Audit

The internal auditor is responsible for conducting independent reviews and evaluations of agency activities and furnishing the agency staff and the board with appraisals, recommendations, and information on activities reviewed. The TRS is subject to the state's Internal Audit Act and the agency's internal audit function complies with the requirements in the act. The internal auditor is independent of agency operations and reports to the board and the executive secretary. In fiscal year 1991, 21 audits were completed with an immediate cost savings of \$95,594. Approximately 86 percent of the audit time was oriented toward the management control area.

### General Counsel

The office of general counsel is responsible for directing and coordinating legal activities of the TRS, maintaining liaison with the Office of the Attorney General and other state officials

relative to legal issues affecting the TRS, and providing legal advice to the board and the TRS staff. The TRS is exempt from Senate Bill 3 of the 72nd Legislature which requires agencies to use the Office of the Attorney General for outside legal counsel.

### Information Services

The information services department is responsible for creation and distribution of publications which inform active members, retirees, and the public concerning TRS services, benefits, and other matters which might affect the TRS retirement program. Printed and audiovisual materials supporting the preretirement education program are also produced.

### Administration Division

The main responsibility of the administration division is to assist the executive secretary with the day-to-day details of internal administration. The administration division directs the general administration of the agency (except for the investments division), oversees personnel and employee relations, assists the executive secretary in developing and maintaining a sound plan of organization, and assists with the development and implementation of effective internal controls within the agency. The administration division is also responsible for developing the agency's six-year strategic plan. During the 72nd Regular Session, the legislature passed legislation requiring most state agencies to develop a six-year strategic plan. The strategic plans are the first step in building a long-term statewide budgeting and planning process. The agency has submitted its plan to the governor, lieutenant governor, speaker of the house of representatives, and several legislative oversight agencies, including the Sunset Advisory Commission. The administrative division also oversees the controller, member benefits, management information services, group insurance and staff services. The administrative division expended \$608,425 and employed 16 personnel in fiscal year 1991.

### Controller

The primary function of the controller is to account for all in-coming and out-going funds. Controlling the flow of the system's funds is accomplished by developing and operating an effective system of accounting, budgeting and controls over all financial activities. Other responsibilities include estimating annual state contributions, processing the various required reports received from the 1,100 school districts, processing and distributing the monthly annuity payroll, and processing refunds of member accounts. Preparing the system's annual report is also a major responsibility of this division. This division operated with 69 employees and expended about \$3.1 million in fiscal year 1991.

### Member Benefits

The primary responsibility of the member benefits division is to help prepare members for retirement by providing them with individual counseling and information booklets and by responding to daily inquiries about retirement benefits and procedures. This division is also

responsible for processing service, disability, and claim applications; maintaining and updating individual retirement accounts. In fiscal year 1991, counseling was provided to 3,173 members and 163 groups of members. The member benefits division operated with 79 employees and expended about \$2.7 million in fiscal year 1991.

#### Management Information Services

The management information services division is responsible for all electronic data processing, communications, and micrographic administrative support functions within the TRS. This division also works with the other division directors in evaluating and coordinating current and future needs for micrographic, communications, and data processing. In fiscal year 1991, the division expended about \$4.5 million and employed 81 staff to support all TRS divisions.

#### Staff Services

The staff services division is responsible for the general management of the TRS physical facilities, mechanical equipment, grounds, and security and safety. Staff services also provides mail, supply, printing and binding support services for the entire agency. The staff services division employed 34 staff and expended about \$2.3 million in fiscal year 1991.

#### Group Insurance

The group insurance division is responsible for the general management of the TRS-Care program. This division was described in detail in an earlier section of the background.

## **OVERALL APPROACH TO REVIEW**



## OVERALL APPROACH TO REVIEW

The Sunset Act requires an assessment of several factors as part of an agency's review. The factors generally include determining if the functions of an agency continue to be needed, if those functions could be better performed by another agency, if functions performed by another agency could be better performed by the agency under review, and if changes are needed to the agency's statute.

The overall approach to the review of the Employees Retirement System and the Teacher Retirement System differed from most sunset reviews in that the agencies are constitutionally created and are not subject to being abolished under the Sunset Act. Therefore, a key aspect of a sunset review, the evaluation of the need for the agency and its functions, was a secondary concern.

An examination was made of the benefits that could be gained by changing the organizational structure of the agencies. Consideration was given to whether some or all of the functions of the ERS and the TRS should be consolidated. While the two agencies do perform many of the same functions, a consolidation would be difficult due to several problems. Primarily, as both agencies are authorized through the Texas Constitution, a constitutional amendment would be necessary for any significant consolidation of the two agency's functions. In addition, the size of each agency's funds individually are large enough that there are limited economies to be derived from consolidating them, as there might be with the combination of smaller funds. The review effort then focused on several policy issues involving ERS and TRS, and on increasing the accountability of the agencies to the legislature.

During the review, a number of activities were undertaken by the staff to gain a better understanding of the two agencies and of retirement systems in general. These included:

- a review of agency documents and reports, state statutes, legislative reports, previous legislation, other states' data, previous evaluations of the agencies' activities, and literature containing background material on retirement systems;
- attendance at public meetings of the ERS and TRS boards;
- a survey of board members, advisory committee members, and groups interested in the activities of the ERS and the TRS to obtain comments on the benefits and drawbacks of issues identified during the review process;
- interviews with key agency staff;

- a survey of the employees of the ERS and TRS requesting the identification of problems at the agencies as well as potential solutions;
- discussions with legislative agencies and committees with responsibility for oversight of the ERS and TRS; and
- phone interviews with individuals knowledgeable about retirement benefits in Texas and in other states.

Out of these activities the overall approach of the review took shape, focusing on the following questions. First, does the organizational structure result in unnecessary duplication or overlap of duties between the ERS and the TRS? Second, does the current structure provide adequate accountability of the agencies to their members and the legislature? Third, are statutory changes needed to ensure that the agencies are providing services to their members in the most efficient and effective manner?

The review resulted in the identification of a series of policy options for consideration by the commission. The potential benefits and drawbacks of each of the policy options are laid out, along with the anticipated fiscal impact of each option. These options were only a small percentage of the total number of issues that were raised during the review. The ones finally selected were based on a good faith effort by the staff to lay out issues of key importance to the commission and the legislature.

## **POLICYMAKING BODY**



**ISSUE 1: Should the ERS Board of Trustees be restructured by adding members with investment and health insurance backgrounds?**

**BACKGROUND**

The ERS Board of Trustees is composed of six members. Three members are appointed with the advice and consent of the senate, one each by the governor, the speaker of the house of representatives, and the chief justice of the Texas Supreme Court. The remaining three members are elected by members and retirees of the system. The only requirements for election are that a person must be a member of the system in the employee class of membership and that a person is not employed by an agency that already has a member on the board. There are no experience or other qualifying requirements for membership on the board.

The TRS Board of Trustees is composed of nine members appointed with the advice and consent of the senate. Three members of the board are direct appointees of the governor, two of which must have demonstrated financial expertise in the private sector and must have broad investment experience, preferably in the investment of pension funds. None of these three members may be a member of or an annuitant of the system. Two members are appointed by the State Board of Education and have no specific statutory qualifications. The remaining four members are appointed by the governor from slates of candidates elected by TRS retirees, public school employees, and higher education employees.

The ERS Board of Trustees is constitutionally required to administer the ERS and administer the funds of the ERS. The board, as trustees of ERS funds, is responsible for ensuring the proper and best investment of those funds. To carry out their investment responsibility, the board sets investment policy for all agency trust funds. Day-to-day activity regarding the investments that reflect that policy is assigned by the board to agency staff. The board is also responsible for developing and administering multiple and complex benefit programs. These programs include the state employees retirement programs; judicial retirement programs; health, life and disability insurance programs for state employees and most higher education employees; a deferred compensation program; and a flexible benefits program.

**CONCLUSION**

The ERS Board of Trustees has no statutory requirements for any members to have particular types of expertise. The board, however, has both constitutional and statutory duties to invest the funds and set policy for very large retirement and insurance programs.

## POLICY OPTION

- **The statute should be amended to expand the ERS Board of Trustees from six to nine members. The three additional members should be appointed by the governor for staggered six-year terms. Two of the three members should have demonstrated financial experience from the private sector and broad investment experience, preferably in the investment of pension funds. One member should have demonstrated experience in developing and implementing employee benefit programs in the private sector, preferably including employee health insurance programs.**

### **BENEFITS**

- ▶ **The board would include members with a broader range of experience in areas where the board makes decisions and sets policy.**
  - The board is responsible for investing over \$8 billion of members retirement funds. Although the board receives advice from their investment advisory committee and agency staff, bringing financial expertise directly into the board's decision-making process could have a positive effect on the quality of those decisions.
  - The board is responsible for setting policy for an employee benefits system that provides health insurance coverage for almost 400,000 state and university employees and their families. Having at least one member on the policy body with outside experience in developing and implementing employee benefit programs could be beneficial to their discussions.
  - None of the current ERS board members has extensive private sector investment or health benefits experience. One current member of the ERS board does have some investment experience, however.
  - The staff of the Teacher Retirement System indicated that having members on the TRS Board of Trustees who have private sector investment expertise has been beneficial to the board in its decision making process.
- ▶ **A larger commission allows for increased ethnic, gender and geographic diversity in commission appointments. In addition, the governor would have increased input into the membership of the policy body of an executive branch agency.**
  - The General Services Commission is an example that shows that greater diversity can be achieved when there is an expansion in the size of a

commission. The General Services Commission was expanded from three to six members in 1991. Four appointments have been made by the governor since that time. Three of the new members are female and two are members of ethnic minority groups. Although the ERS board is also composed of six members, the governor can only appoint one member, compared to six appointments to the General Services Commission.

## **DRAWBACKS**

- ▶ **The board gets all the expertise it needs from ERS staff, the investment advisory committee, outside investment advisors and the group benefits advisory committee (GBAC).**
  - The investment advisory committee is composed of five members with experience in financial institutions or other businesses making investment decisions. The investment advisory committee reviews investment policies and performance of ERS investments and makes recommendations to the board and staff. Expertise is also provided by outside investment advisors employed by the ERS to assist in investing certain portions of the system's portfolio of investments.
  - Effective November 1, 1992, the GBAC will be composed of 25 members, 16 of whom will be appointed or elected to represent state agencies and retirees, seven of whom will be appointed or elected to represent higher education employees and retirees and two representatives to be appointed by the governor and lieutenant governor. The committee is statutorily directed to advise and consult with the ERS Board of Trustees on matters concerning ERS benefits, other than the retirement program. The committee members are statutorily directed to obtain input from fellow employees regarding benefits.
- ▶ **There is no need to increase the size of the board because the current composition is working fine and the increase would dilute the elected representation of state employees and retirees.**
  - No particular problems have been identified related to lack of specific expertise on the ERS Board of Trustees.
  - Employees and retirees currently elect one-half of the membership of the board. Under this policy option, only one-third of the board would be elected to represent employees and retirees.
- ▶ **People with investment experience may bring biases with them that may not be appropriate to the agency's mission.**

- A member may have a particular bias, for example, towards riskier investments than is appropriate for this type of operation. That member could have undue influence on the investment strategy of the agency.
- ▶ **A larger board is more costly.**
  - The budget for the ERS Board of Trustees is approximately \$24,000 per year. This figure would be increased by about \$8,000 a year if the board is expanded to nine members.

**FISCAL IMPACT**

Based on ERS board expenditures of about \$24,000 in fiscal year 1991, expanding the board to nine members would increase costs by about \$8,000 to a total of \$32,000 for fiscal year 1994. Funding for board activities is obtained from investment earnings of the retirement and insurance funds administered by the board. The retirement fund presently pays about 55 percent of board costs, while the insurance fund pays about 45 percent of board costs.

<b>Fiscal Year</b>	<b>Cost to the Employees Retirement and Insurance Funds</b>
1994	\$ 8,000
1995	\$ 8,000
1996	\$ 8,000
1997	\$ 8,000
1998	\$ 8,000

## **OVERALL ADMINISTRATION**

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**ISSUE 2: Should the ERS and the TRS be required in statute to examine the cost-effectiveness of entering into interagency contracts for performance of like functions?**

## **BACKGROUND**

The ERS and the TRS are both agencies that were established to administer public employee retirement programs. The ERS administers retirement programs for state employees, judicial system personnel, and a supplemental retirement program for state law enforcement personnel. The ERS also manages a health insurance program and several other benefit programs. The TRS administers retirement programs for public school and higher education employees and manages a health insurance program for TRS retirees. As these duties are quite similar, the agencies both perform many similar functions and activities.

As administrators of retirement programs, the ERS and the TRS both oversee the retirement accounts of members of their respective systems, calculate benefit payments upon retirement of employees, process payments to retirees, answer questions of members and retirees and perform other related activities. As managers of large retirement funds, the agencies invest in the securities and fixed income markets, perform economic analyses of the markets, research potential market transactions, contract for actuarial analyses of the retirement funds and perform other similar duties. Although both agencies administer health insurance programs, the ERS program is much larger in scope than the TRS managed TRS-Care program. However, some of the activities involved in the administration of the health insurance programs are also similar.

Although the functions and activities described above are quite similar, both agencies have always operated completely independently. Both agencies have considerable investments in infrastructure, such as computer systems, to perform these duties. However, the agencies do not presently attempt to determine whether there are any similar activities that could be more cost-effectively performed by one agency or another under an interagency contract.

## **CONCLUSION**

Although many details of the programs differ, the ERS and the TRS have similar overall duties and responsibilities. As a result, both agencies perform some of the same functions, particularly in areas related to their retirement programs. However, the agencies do not presently perform any activities jointly, nor do they examine whether there are any potential cost savings from working together to perform any similar functions.

## **POLICY OPTION**

- **The statutes for the ERS and the TRS should be amended to require the agencies to examine the potential for cost savings from contracting with each other for services that are currently performed in both agencies. In addition:**
  - **the examination of similar functions should take place at least every two years;**
  - **the agencies should request the assistance of the state auditor in performing the examinations; and**
  - **the agencies should report the results of each biennial examination and any benefits achieved through interagency contracting to the Legislative Budget Board and the Governor's Office.**

In the first examination, the TRS and the ERS would be expected to concentrate their efforts in identifying and examining one or two major activities. If cost savings are identified, the agencies would contract to perform the activities in the most cost-effective manner. The process set up through their efforts in the first examination would then provide the foundation for further evaluations.

The Office of the State Auditor should be a valuable source of assistance in the examination effort. The auditor examines many similar activities in the two agencies on a regular basis. As a result, the audit staff would have a unique perspective on the compatibility of similar activities of the two agencies.

### **BENEFITS**

- ▶ **Cost savings would be generated through contracts to perform similar functions in one agency or the other.**
  - Both agencies perform activities such as payment of monthly benefits to members, economic analysis for investment purposes, market research, managing members' pension fund accounts, accounting, payroll, printing and other operations. Each of these and other activities have the potential for yielding cost savings if combined. Requiring the ERS and the TRS to examine the potential for cost savings will provide the information necessary to determine if similar functions could be combined.
- ▶ **Cost savings to the retirement funds improves their financial status and could result in slightly decreased state contributions.**

- Improvements in the financial health of the retirement funds can lessen the need for the contribution of state dollars into the fund. If the state's budget picture continues to remain tight, any lessening of the need for state dollars would be helpful.
- ▶ **The option presented will help the boards meet their fiduciary responsibilities to operate the systems in the most cost-effective manner possible.**

#### **DRAWBACKS**

- ▶ **The money, time and effort spent on performing the examinations would not be worth the limited potential cost savings involved.**
  - Both agencies have developed independent systems to perform many of the activities discussed above. It would be costly to remove a system that is properly functioning to combine it with another agency's system. For example, both agencies have developed extensive computer systems to perform activities such as accounting, paying members' benefits, and managing members' accounts. It would be a costly and likely unproductive effort to examine whether these systems could or should be combined.
  - There is the potential that the cost of performing the evaluations could outweigh any cost savings obtained through interagency contracts for performance of similar functions.
- ▶ **Each board has a fiduciary responsibility for the activities of their respective systems. The control over administrative functions may be lessened if a function is being performed by another agency through an interagency contract.**
  - Each board can effect changes in agency operation through the executive director that is hired by the board. If an activity is actually being performed at another agency, the control over that activity is more removed. As the boards have a fiduciary responsibility for the administration of the agency and the proper expenditure of the funds, any reduction in control could hinder the ability to perform their duties to the fullest extent.

#### **FISCAL IMPACT**

Cost savings are expected once the examination process is implemented. However, some initial costs will be incurred as a process is developed to examine duplicated functions of the two agencies.



**ISSUE 3: Should the operating expenses of the ERS and the TRS be appropriated to the agencies by the legislature?**

**BACKGROUND**

Almost all state agencies are subject to the legislative appropriations process for their operating expenses. Through this process, state agencies submit appropriations requests for the upcoming biennium. The request is evaluated by the Legislative Budget Board, the Governor's Office and the legislature. The legislature appropriates money for the operation of state agencies subject to veto by the governor.

The appropriations process gives the legislature a great deal of control over an agency since the legislature directly controls the agency's purse-strings. However, the ERS and the TRS are not subject to the appropriations process. In the case of the ERS and the TRS, those agencies themselves control the amount of money to be spent to run the agencies. The staffs make budget estimates of the funding necessary to perform agency operations. The final budgets are approved by the agency's boards. The money to pay these expenses comes from interest earnings of the various funds maintained by the agencies and from membership fees. These funds are held with the state treasury. The amounts of money budgeted by the boards to run the agencies are significant. In fiscal year 1992, the budgets amounted to about \$20 million for the ERS and about \$27 million for the TRS, roughly the size of the budgets for the Library and Archives Commission and the Texas Alcoholic Beverage Commission respectively.

The state does appropriate significant contributions to the retirement and health insurance funds for benefits for retirees and current members. For example, the state appropriated \$187 million to the Employees Retirement Fund and \$867 million to the Teachers Retirement Fund in fiscal year 1992. These contributions are not used for operating expenses.

**CONCLUSION**

The current method of financing operating costs at the agencies bypasses the appropriations process. Most state agencies are subject to the appropriations process which gives the legislature greater control over agency expenditures. Even though the ERS and the TRS receive considerable appropriations for providing benefits to state and educational employees and retirees, the state has little say in the administrative systems in place to provide services.

## POLICY OPTION

- **The statutes governing the ERS and TRS should be changed to:**
  - **make the agencies subject to the appropriations process for their basic level of operating expenses;**
  - **allow the agencies to supplement these appropriations if necessary from their other funds to safeguard their role as fiduciaries of the systems; and**
  - **require the agencies to report any supplementation of their appropriated operating budget to the LBB and the governor's office.**

This policy option subjects the agencies to the state appropriations process to obtain their basic level of operating expenses. However, the policy option still allows the agencies the flexibility to supplement these amounts from their own funds, subject to reporting requirements. This flexibility is necessary to protect the agencies' legal role as fiduciaries. As fiduciaries, the agencies are responsible for safeguarding members' funds. Under certain circumstances, the boards' fiduciary responsibilities could require expenditure of additional amounts beyond that appropriated for operating expenses. For example, if the ERS or the TRS was not appropriated sufficient funds to obtain the expertise needed to properly invest the assets of their fund, the board could feel obligated to supplement the appropriation to obtain the expertise they felt was necessary.

Appropriations to the ERS and the TRS for their operating budgets would be accomplished without any additional expenditures of funds. Each biennium the state appropriates contributions to the funds of both systems. These contributions could be reduced by the amount of the appropriation for operating expenses. That amount would be placed in the treasury and appropriated to the agencies for operating expenses. The investment earnings of the two systems that are presently used for operating expenses would just remain in their respective funds to replace the lower state contribution. The net effect is that money for operating expenses simply comes from a different source of funds going to the two agencies.

### **BENEFITS**

- ▶ **This option would require the agencies to be subject to the standard oversight mechanism regarding funds appropriated for operating programs.**
  - There are extensive oversight mechanisms in place through the appropriations process to review an agency's performance and future budgetary needs. The ERS and the TRS are presently exempt from these oversight mechanisms.

Requiring ERS and TRS operating funds to go through the appropriations process would ensure that the scrutiny of their budgets and performance occurs through entities other than just the boards of trustees.

- ▶ **Requiring appropriations for operating expenses from the state would make the ERS and the TRS subject to Article V of the Appropriations Act.**
  - Article V of the state appropriations bill sets state policies and places limits on a variety of expenses state agencies can incur, such as travel expenses, transportation costs, job classifications, and salaries. Currently, neither the ERS nor the TRS are required to follow these policies and limitations and therefore can stray from policies which most other state agencies are required to follow. Requiring these agencies to follow Article V may result in savings due to more stringent requirements and better oversight.
- ▶ **This option would give a degree of flexibility to the agencies in terms of their operating expenses but still provide scrutiny by reporting any supplementary money used.**
  - Because the ERS and the TRS would be allowed to supplement their appropriations from their investment earnings if necessary, they would still be able to fully carry out their duties as fiduciaries. The ability to supplement appropriations would provide the agencies with a degree of flexibility over operating expenses which can be used to cover unforeseen expenditures or increased costs. However, having this flexibility monitored by the LBB and the governor's office should provide the oversight necessary to deter abuse of their ability to supplement expenditures.

#### **DRAWBACKS**

- ▶ **Putting such a mechanism in place is redundant because of the fiduciary responsibility of the board of trustees and members of the staff.**
  - Members of the boards of trustees and certain members of the staff are fiduciaries of the systems. This means that they are personally responsible for the performance of the system and must act solely in the best interests of the systems. This responsibility itself is a check against unnecessary administrative costs and placing another layer on top of it would not assure control of administrative costs.
- ▶ **Placing the ERS and the TRS in the appropriations process could be interpreted as unconstitutional because such a change could interfere with operating the systems in a manner the boards feel is most prudent.**

- The state constitution requires that the boards of trustees administer the systems in a manner they consider prudent. Placing the ERS and the TRS in the appropriations process runs the risk of the legislature mandating policies which the board may feel are not prudent. This would result in requiring the boards to operate the systems in a manner contrary to their constitutional mandate.
- ▶ **Subjecting the agencies' funds to the state appropriations process runs the risk of losing the tax-exempt status of the funds if violations of the Internal Revenue Code should occur.**
  - The Internal Revenue Code requires a pension fund to be run for the sole benefit of its members and that the body of the fund not be diverted. Placing the agencies in the appropriations process runs the risk of violating these provisions of the Internal Revenue Code because such a mechanism would no longer require the boards to act solely in the best interest of their members. Instead, they would be required to act more in accordance with the desires of the legislature. The members of the system would be harmed by disqualifying the retirement funds from tax-exempt status if the IRS viewed such a mechanism as violating the Internal Revenue Code.
- ▶ **The ERS and the TRS are already subject to review from several oversight agencies.**
  - Several state agencies oversee the activities of the ERS and TRS. For example, the Pension Review Board examines the fiduciary soundness of both systems. The Legislative Budget Board oversees the requests both agencies make for state contributions and performs biennial performance evaluations. In addition, the state auditor performs regular financial and management audits of the two systems.

#### **FISCAL IMPACT**

Placing the ERS and the TRS operating budgets in the appropriations process could result in future savings through greater legislative oversight. However, the fiscal impact cannot be determined at this time.

# **EVALUATION OF PROGRAMS**



**ISSUE 4: Should transfer of retirement service credit between the Teacher Retirement System and the Employees Retirement System be authorized?**

**BACKGROUND**

Prior to 1980, the Texas Constitution only authorized the legislature to credit years of service for people transferring between the Teacher Retirement System (TRS) and the Employees Retirement System (ERS) by allowing the direct transfer of service credit between the two systems. Transfer of service allowed an employee to combine years of service under both systems and use the final average salary to calculate benefits. This would be much the same as if the employee had been employed in one system for the same amount of time.

In 1980, the constitution was amended to authorize a second approach to the direct transfer of service credit approach. This approach provides for proportionate or fractional benefits. The statute was changed at that time to eliminate the transfer of service credit approach and to require the use of the proportionate benefits approach. This is the approach currently authorized in law. Under this approach, an employee may use the combined years of service credit from both systems to qualify for retirement benefits, but benefits are based on the salaries and service at each system and the benefits are paid separately from each system's funds. Since service earned early in a person's career would likely be of a lower average salary, the benefits from previous employment under the proportionate approach are generally not as great as under a transfer of service approach. In addition to the ERS and TRS, proportional benefits are also authorized for employees transferring to or from the Judicial Retirement System of Texas, the Texas Municipal Retirement System, the Texas County and District Retirement System, and the City of Austin Retirement System.

To get a better picture of the differences between these two approaches, consider Mary Jones, a 65 year old employee with four years of service as a member of the TRS who then transferred to a state agency under the ERS system and worked another 16 years. Her final average salary under the TRS was \$20,000, while her final average salary under the ERS was \$40,000. Under either approach, the combined years of service would enable her to retire with 20 years of combined TRS and ERS service credit. Under a proportionate benefits approach, Ms. Jones would receive an annual benefit of \$1,600 from the TRS based on two percent of her final average salary of \$20,000 multiplied by her four years of service under the TRS. She would also receive an annual benefit of \$12,800 from the ERS based on two percent of her final average salary of \$40,000 multiplied by her 16 years of service. Therefore, under the proportionate approach, Ms. Jones would receive a total of \$14,400 annually. In contrast, under the transfer of service credit approach, she would receive an annual benefit of \$16,000 based on two percent of her

final average salary of \$40,000 multiplied by her total 20 years of service. The result is a difference of \$1600 annually or \$133.33 per month.

The reason the law was changed in 1980 to use the proportionate benefits approach was due to concerns that the ERS was incurring significant actuarial costs under the transfer of service approach. Under the transfer of service approach, assets maintained for a member in one system transfer to the other system when the employee switches retirement systems. Since the TRS has significantly more members, larger numbers of employees were transferring from the TRS to ERS. However, asset transfers were not sufficient to cover the costs to the ERS when these employees later retired.

Since the adoption of the proportionate benefits system in 1980, concerns have been raised by people transferring between the systems about the equity of the proportionate benefits approach. The proportionate benefits approach almost always results in lower retirement payments to those employees whose retirement credit is split between the two systems. Contacts with both state employee and education interest groups indicated considerable interest in developing an equitable system to allow transfer of service credit between the ERS and TRS.

## CONCLUSION

Employees transferring between the public schools and universities covered by the TRS and the state agencies covered by the ERS cannot obtain comparable retirement benefits to employees covered by only one of the systems throughout their career. Allowing transfer of service credit between the two systems is important to members of both the ERS and TRS because this approach results in higher retirement benefits.

## POLICY OPTION

- **The statute should be changed to require the ERS and TRS to develop a system for transfer of service credit. The statutory changes should:**
  - **require that the ERS and TRS develop a system that minimizes the actuarial impacts on either of the retirement systems;**
  - **require the ERS and TRS to adopt the system as a Memorandum of Understanding (MOU). The MOU should be adopted in rules by February 1, 1994. Transfers of service credit should be allowed beginning September 1, 1994. The MOU may include restrictions on transfers necessary to avoid significant negative actuarial impacts on either system; and**

- **authorize the transfer of funds between the systems to cover costs of the actuarial obligation of the transferring employees.**

This option would be limited to persons retiring after September 1, 1994, and would not be for use by persons who have already retired. Persons who have previously transferred employment but have not retired yet would be eligible for these benefits, unless the member had withdrawn their contributions from the retirement system that the member is transferring from. Employees would not be limited in their ability to transfer between the systems through a career. Fund transfers would occur when a person transferred employment, not upon retirement. Persons moving into any of the other systems covered under the proportionate benefits program would still utilize the proportionate approach for calculating their benefits. These other systems are the Judicial Retirement System of Texas, the Texas Municipal Retirement System, the Texas County and District Retirement System, and the City of Austin Retirement System.

Several alternative approaches have been discussed by the ERS and the TRS for transferring retirement service credit equitably between the two systems. At a minimum, the member and state contributions, as well as the earnings on these contributions, would need to be transferred to the new system. Other more complicated approaches have also been under consideration by the ERS and the TRS. The systems would be responsible for evaluating the different approaches and adopting the one that best meets their respective needs.

## BENEFITS

- ▶ **Employees moving between the ERS and the TRS would be able to obtain full credit for their combined years of public service, whether in the ERS or the TRS, as if they had been in one system throughout their career.**
- Employees of both systems generally consider their work in any of these systems to be public service for the state, whether it be in a state agency, public college or university or public school. However, employees of the Texas Education Agency (TEA) cannot transfer service credit to other state agencies because TEA employees are members of the TRS, while other state employees are members of the ERS. In addition, there is no transferability of retirement service between state agencies and public colleges and universities.
- Allowing transferring employees to receive full service credit will increase their retirement benefits to the level they would have received had their service been credited under only one of the two state retirement systems.

- ▶ **This approach would give both agencies the ability to jointly work out a system that would best meet their respective needs.**
  - Both the ERS and TRS have already begun investigating different approaches to transferring service credit between the two systems in response to a request from the House Retirement and Aging Committee. The systems themselves have the expertise and are in the best position to determine the approach that is going to come the closest to minimizing any negative impacts on either system.
  
- ▶ **Employees would only have to deal with one system upon retirement.**
  - Although basic payments are calculated similarly by the two systems, each system has a set of optional retirement plans and other features that must be decided on by the member. Currently under proportionate benefits, members who have transferred from one system to another must deal with each of these systems separately in setting up their retirement benefits. Members then receive separate monthly checks from the two systems. Any changes or payment problems must be dealt with separately with each system.
  
- ▶ **The legislature would no longer have to make special provisions for employees being transferred between the systems due to other legislative action.**
  - In the past, special statutory provisions had to be made when legislative action resulted in certain employees' jobs being transferred between the two retirement systems. These provisions had to provide specifically for the transfer of retirement service credit of these employees to the new system. For example, in 1987, the legislature transferred a number of special education teachers who had been employed by the Texas Department of Mental Health and Mental Retardation into the public school system. That same session the legislature closed the Texas Research Institute of Mental Sciences and transferred a number of the state employees to the public university system. In both cases, special arrangements had to be made to ensure that the employees' retirement benefits would not be negatively affected, as the change in jobs was not their choice but legislatively mandated. Basically, employees' membership was transferred from one system to the other. Each of the systems agreed to a one-time transfer of funds to cover the actuarial liability of assuming these new members.

## DRAWBACKS

- ▶ **Authorizing transfer of credit between the ERS and TRS would result in additional costs to the systems to provide increased retirement benefits to members that have served in both systems.**
  - The increased costs would be the difference between what transferring members would receive in benefits under the proportionate benefits plan and what the members would receive if their retirement service credit is fully transferred. Since the transfer of service credit approach will result in higher retirement benefits for employees with service under both the ERS and TRS, the change will result in additional costs overall, regardless of which calculation method is adopted by the systems.
  
- ▶ **There are many complications involved in establishing a system that will be equitable to both ERS and TRS. Difficulties could arise if the systems cannot agree on a calculation method that addresses each system's concerns.**
  - One difficulty is that the definition of a year of service credit differs between the TRS and the ERS. Currently, the TRS calculates benefits on a yearly basis and members earn credit for a year of service once they have worked at least 4.5 months in a year. In contrast, ERS calculates benefits on a monthly basis and members must work the full 12 months to get credit for a year of service.
  - Another concern is that while many of the differences between the benefits offered by ERS and TRS have been equalized, some differences still exist. For example, the member contribution for ERS is six percent of salary, while for TRS members it is 6.4 percent of salary. In addition, the ERS state contribution is currently 6.43 percent of salary, while for TRS it is 7.31 percent of salary. These differences would have to be taken into account by the calculation method adopted by the systems.
  - The TRS allows members to establish credit for out-of-state teaching service. Similar credit is not available to ERS members. The systems would have to address whether such credit would be transferable.
  
- ▶ **Providing for the specifics of the system to be developed by the agencies as an MOU in rules does not ensure the stability that would be obtained by placing the system in statute.**
  - Under the MOU approach, the system could be subject to changes by the agencies as membership of the ERS and TRS boards changed. If this

resulted in numerous or frequent changes, members of the systems would not know from year to year how the system would work.

### FISCAL IMPACT

There would be a fiscal impact on the systems' retirement funds due to the increased benefits that would be made available to transferring members. The impact is not anticipated to be significant relative to the total size of either system and should not materially affect either systems's funding period. However, no fiscal estimate could be made due to the fact that the fiscal impact on each fund will be dependent on the calculation method agreed on by the two agencies to transfer an employee's retirement obligation. In addition, calculating the fiscal impact is complicated by the difficulty of estimating the number of employees that may transfer employment in the future, but it is not anticipated to involve a significant number of employees each year.

**ISSUE 5: Should the statutory requirement for the ERS to provide an optional health insurance program for school district employees be changed or eliminated?**

**BACKGROUND**

The 72nd Legislature, as part of H.B. 2885, mandated that a health insurance program comparable to that provided to state employees be provided to public school employees. The bill did not set out details of what constitutes a "comparable" health insurance program. School districts were required to provide this level of coverage and certify to the ERS that it would be in place by September 1, 1992. As a second option, the district could choose to participate in a statewide insurance program administered by the ERS. School districts that elect to participate in the ERS-administered insurance program must contribute the employee-only cost of the plan, not to exceed the amount contributed by the state for its employees. The monthly state contribution for employee-only plans is \$178.23 for fiscal year 1993.

The legislature also set up two mechanisms for school districts to participate in the state plan. First, districts may elect to participate in the state's Uniform Group Insurance Program (UGIP) *unless* the ERS board of trustees determines that such participation would have a significant adverse impact on the UGIP. If a determination of adverse impact is made, the ERS may establish a separate plan for public school employees. Upon recommendations of consulting actuaries, the ERS board of trustees determined that there would be a significant adverse impact on the UGIP due to the optional participation provision for school districts. The ERS determined that primarily those school districts that cannot obtain less expensive coverage than the UGIP would choose to participate. The reasons that result in higher costs for a district's own program would continue in place under the UGIP and would lead to higher expenses for the UGIP. School districts that have lower risks and lower costs would not choose to participate in UGIP and would, therefore, not be available to "balance out" the impact of higher cost districts on the UGIP.

The ERS has developed a framework for a separate health insurance plan for public school employees, but has determined that the plan would not be financially sound in the absence of an adequate contingency reserve fund to cover any expenses that exceed available funds. The reasons stem from the same conditions as discussed in the paragraph above. Due to the optional nature of the program, higher risk and therefore higher cost districts would primarily choose to participate. Also, the number of districts and employees and their risk characteristics would not be known in advance. The ERS actuary determined that the above reasons would make it unlikely that a private insurance carrier would be able to determine the costs and the risks of the insurance coverage and would therefore not choose to participate.

Another option considered was to self-insure the program. However, the same expenses and risks would apply to the self-insured program and the consulting actuary determined that the self-funded program would sustain losses in its early years and possibly indefinitely. Since no funds were appropriated to establish a contingency reserve fund, the program could not actually sustain losses, and claims would have to go unpaid until funds were available to pay the providers. The ERS board of trustees determined that this would not be a viable way to proceed and delayed implementation of a self-funded plan until such time as an adequate contingency reserve fund is available.

## CONCLUSION

Although the ERS is required by statute to establish a health insurance program for public school employees, there are several difficulties in establishing either of the program alternatives set out in statute for the ERS. Allowing school districts the option to choose to enter the state employees' UGIP results in only those districts with high health care costs and those that have difficulty obtaining insurance being likely to choose to participate. This situation would have a significant adverse impact on the UGIP program. The second option authorized by statute allows the ERS to create a separate health insurance program for the school districts that choose to participate. The ERS has delayed implementation of the separate program because, as currently structured in statute, the program would not be financially sound. The ERS actuary has determined that such a program is likely to incur losses in at least the first few years. However, no funds were appropriated to set up a self-insured contingency reserve fund to ensure that claims against the fund would be paid.

## POLICY OPTIONS

Three options have been developed that set out alternative methods to solve the problems with implementing a health insurance program for school district employees. The three options range from requiring the ERS to allow school districts in the UGIP, to eliminating the requirement for ERS to provide a program, to transferring the program to TRS and providing a funding method to allow the program to begin. These three options are explained in detail in the following material.

### POLICY OPTION 1

- **The statute should be amended to:**
  - **require the ERS to provide school districts a *one-time* opportunity to choose to enter the UGIP or to establish a separate program for districts to participate in;**

- **remove the requirement for the ERS to consider whether there would be a significant adverse impact on the UGIP; and**
- **require ERS to allow school districts to participate in the UGIP if the ERS did not set up a separate insurance program for school district employees.**

Under this approach, the statute should require school districts to be given a one-time opportunity to participate in an ERS-operated health insurance program. If a district chooses not to participate in the state plan, under current law the district must offer group health insurance that is comparable to health coverage provided state employees.

## **BENEFITS**

- ▶ **All school district employees would have health insurance available to them that is at least equivalent to the basic health coverage offered to state employees.**
  - Since state law requires all districts to offer health insurance comparable to that of state employees, this policy option would ensure that a method is available for districts to obtain health insurance for their employees through the state. In particular, districts that have not obtained health insurance for their employees, often due to high costs, would have a way to obtain that insurance at reasonable rates.
- ▶ **The impact on the UGIP could be very limited.**
  - The ERS recently surveyed school districts as to their interest in entering a state-operated health insurance plan. As of the beginning of September, only 25 to 30 of the 1071 school districts in Texas expressed interest in entering a health insurance plan under the ERS.
  - There are about 400,000 employees and their dependents in the UGIP as of September 1, 1992. Adding the employees from 25 or 30 small districts may not have a large impact on the costs of the UGIP program as a whole.
- ▶ **Requiring school districts to make a one-time election as to whether to participate in the state plan allows rates to be set by defining a population to be insured.**
  - Once the districts that choose to enter the state-operated plan have done so, the size and characteristics of the group to be insured become known. At this point, rates can be set to reflect the anticipated costs of the group. The ERS would also have the information that would help them choose whether to contract out for an insurance plan or to self-insure.

- A provision for a one-time decision to enter the state-operated plan also ensures that districts will not leave the plan when they feel they can get better rates from the private sector and get back in when other options are more costly. This type of jumping would leave the state-operated plan only bearing the burden of districts' high cost years. As a result, rates for participating employees could be high. Requiring districts to make a one-time decision on whether to participate in the program would alleviate this problem.

#### **DRAWBACKS**

- ▶ **There would be a significant adverse impact on the UGIP. Costs would rise and/or benefits would decrease.**
  - The ERS Board of Trustees, with the assistance of their consulting actuary, determined that allowing school districts to elect to participate in the UGIP would have significant adverse impacts on the plan. Although the impact may be partially minimized by the one-time decision by school districts on whether to participate, any adverse impact would result in state and university employees subsidizing school district employees' health insurance costs or in the state having to increase general revenue contributions to the health insurance fund. Alternatively, the state could choose to reduce benefits instead of increasing employee costs or the state contribution.
- ▶ **Costs of providing employee health insurance would still go up for many school districts and district employees.**
  - Districts that provide no insurance, or a low level of insurance at the present time will expend increased funds to obtain the level of coverage required by the state. Some of these increased costs would likely be passed on to district employees through higher rates. The school districts that participate in the state plan would still be required to contribute the same amount per employee as the state contributes for state employees. This amount is currently 178.23 per month, which may be higher than many districts currently pay for their coverage.
- ▶ **The one-time decision for districts to choose to participate in the plan is too inflexible.**
  - The provision for a one-time choice to enter a state-operated health insurance program does not provide sufficient flexibility for districts to obtain health insurance at the lowest possible cost. If a district could obtain a less expensive health insurance plan at a later time, they would be prevented from doing so under this approach.

## FISCAL IMPACT

If there is an adverse impact on the UGIP as predicted by the ERS, costs of the program would rise unless benefits are reduced. Funding would need to be increased either through a higher state contribution or higher employee costs. Without further data on the extent of the adverse impact on the UGIP, the amounts of funds needed cannot be estimated.

## POLICY OPTION 2

- **The statutory requirement for the ERS to provide an optional health insurance program for school district employees should be eliminated.**

Under this approach, each district would be responsible for arranging to obtain their own employee health insurance. The mandate for school districts to offer employee health insurance comparable to the health insurance offered to state employees would remain, but the state would not offer the option for districts to enter a statewide health insurance program.

## BENEFITS

- ▶ **Removing the requirement for the ERS to administer a public school employees health insurance program would ensure that no adverse impact on the UGIP would occur.**
  - The ERS board with the assistance of their consulting actuary determined that, if school districts were allowed to participate in an ERS health insurance program at their option, the districts having difficulty obtaining insurance or having high cost insurance would be those choosing to participate. Allowing participation of districts with high health care costs would drive up UGIP costs.
- ▶ **Option two would ensure that state and university employees would not be required to subsidize the inclusion of higher cost school districts in the UGIP.**
  - Employees of state agencies and most universities are not given a choice of whether to participate in the UGIP or their own insurance program. This results in agencies or universities that have higher health insurance costs as individual institutions balancing out those that have lower costs. However, only including higher cost school districts results in agencies and university employees providing the balance and not other school districts whose costs may be lower.

- ▶ **The option presented would remove the statutory direction to create a program that may not be financially sound.**
  - The ERS was authorized to create a separate health insurance program for school districts if there would be a significant adverse impact of including the districts in the UGIP. Due to expected losses of the separate program in the first few years, a contingency reserve fund would be necessary; however, no funds were appropriated for this purpose.

#### **DRAWBACKS**

- ▶ **Removing the program would not address the burden on local school districts to pay for health insurance coverage that is comparable to state employees.**
  - The two options given to ERS by the statute were intended to provide a lower cost alternative of obtaining comparable insurance to school districts that have limited resources or high health care insurance costs. Without a viable alternative, districts in this situation may have to increase local taxes or reduce educational programs to meet the health care insurance mandate.
- ▶ **Under option two, districts would continue to be required to provide a health insurance plan that is "comparable" to the state employees' plan. However, "comparable" would still not be defined, and there would be no oversight of the comparability requirement.**
  - Under current law, if districts choose not to participate in a state plan, they must certify to the ERS that they offer their employees a health insurance plan that is comparable to the state employees' plan. The comparability provision is not defined in statute. If the ERS is not involved in district health insurance programs, districts would be left to determine on their own whether their programs are comparable to the state employees' program.

#### **FISCAL IMPACT**

Although there would not be a direct fiscal impact on the state related to this option, there could be a significant impact on certain local school districts to provide the mandated level of insurance coverage. The actual impact on local districts cannot be estimated.

### POLICY OPTION 3

- **The statutory requirement for the ERS to provide an optional health insurance program for school district employees should be transferred to the TRS and funded through school district employee contributions. The statutory provision authorizing the ERS to include school districts in the UGIP should be removed. In addition, the statute should be amended to include the following requirements:**
  - **A \$10 per year health insurance fee on all school district employees should be established to provide funding for a contingency reserve fund and administration of the school district employees health insurance program. The fee should remain in place until TRS determines the fee is no longer necessary to support the program. Higher education employees that are TRS members should not be required to pay the fee.**
  - **Implementation of the program should begin one year after the fee is implemented to generate revenue for the contingency fund and program start-up costs.**
  - **Implementation of the current statutory provisions regarding school districts' health insurance programs should be delayed until the state program is implemented.**
  - **The TRS should be authorized to develop rules to prevent districts from placing only their high-cost employees in the state program. For example, TRS could consider rules relating to limiting participating school districts from also offering other health insurance plans or from offering additional compensation to employees in lieu of participating in the state program.**
  - **To provide program stability, school districts that decide to participate in the program should be required to continue participation for a period of time to be determined by TRS in rules.**
  - **The TRS should be required to assess the benefits of entering into an interagency contract with the ERS for assistance in developing and/or administering the teachers health insurance program.**
  - **All other statutory provisions established for the program as set up for the ERS would remain in place for the TRS.**

## BENEFITS

- ▶ **A stable program for school districts that have difficulty obtaining reasonably-priced health insurance for employees would be established.**
  - As discussed previously, the ERS board has decided not to allow school districts to enter the UGIP due to the significant adverse impact on that plan. The ERS board has also delayed implementation of the separate health insurance program because, as currently structured in statute, the program would not be financially sound. Option three would provide monies for a contingency fund and allow the program to get off the ground.
  
- ▶ **Enabling the health insurance program to begin helps ensure that all school district employees across the state will have access to health care insurance.**
  - A 1991 study by the TRS and the TEA found that 132 school districts with about 7,500 employees did not provide group health insurance. A majority of those districts without the insurance indicated that it is not provided due to the cost of the coverage. Once the state-operated program is established, districts can meet the state mandate for providing health insurance to employees by paying the same amount per employee that the state pays for their employees' health insurance.
  
- ▶ **Transferring the responsibility for the school district employees health insurance program to the TRS would place responsibility for that program in an agency that regularly works with school districts and their employees.**
  - About 400,000 of TRS members are school district employees. The TRS' primary job is to work with these employees and retirees to provide the retirement portion of their benefit package.
  
- ▶ **Establishing funding for the program and transferring it to the TRS would ensure that state and university employees would not be required to subsidize the inclusion of higher cost school districts in the UGIP.**
  - If the addition of higher cost school districts to the UGIP would have a significant adverse impact on the plan as anticipated, state and university employees would likely subsidize these costs through higher future rates or a reduction in benefits. Moving the plan to TRS removes this potential liability.

## **DRAWBACKS**

- ▶ **The \$4 million per year that would be raised through the \$10 fee would not provide an adequate contingency reserve fund.**
  - The ERS has estimated that a \$15 million to \$16 million contingency reserve fund would be needed to operate the program. These figures were based on an assumption that about 5,000 employees may participate in the program. Therefore, for example, bringing in \$12 million over three years would not provide the financial stability that is needed. In addition, TRS estimates that start-up costs would be \$2 million to \$5 million.
  
- ▶ **The costs to employees of school districts that choose to participate could be very high.**
  - If only districts that are unable to obtain insurance in the private sector and those districts that have very high cost insurance choose to participate, program costs would be high. This would require the TRS to set rates high enough to recover costs of the health insurance benefits. Since the statute provides for districts to pay the "employee only" rate that the state pays for its employees (currently \$178.23), district employees would have to pay any portion of the rate that is above that amount.
  
- ▶ **Continuing to allow school districts to participate on a voluntary basis will result in only districts with high health care insurance costs choosing to participate. This situation could place the program in jeopardy.**
  - As discussed previously, having only districts with high health insurance costs participate would make it very costly to operate the program. If the program costs are too high, many districts may not choose to participate, which could undermine the program. The TRS indicated that, in order for a school district employee health insurance program to be successful, participation must be mandatory, although some large districts could be exempted.
  
- ▶ **Delaying implementation until the TRS determines there is a sufficient contingency reserve fund may be costly for some districts. School districts need health insurance assistance now.**
  - If the mandate for school districts to offer health insurance that is comparable to the state employees' plan is not also delayed, school districts without insurance may have to pay very high rates to obtain the insurance until the state-operated program is available.

- ▶ **The state, instead of school district employees, should pay the costs of establishing a health insurance contingency fund.**
  - School district employees should not be assessed a \$10 annual fee to fund a program that most of them will not use. Funding the program should be the responsibility of the state. In addition, school district employees cannot afford any reductions in their salaries. For example, the average salaries of Texas school teachers are already 31st in the nation. Placing an additional burden on those salaries would just cause more harm.

#### **FISCAL IMPACT**

The \$10 per year annual fee for school district employees would generate about \$4 million per year for the health insurance contingency fund. In fiscal year 1994, a portion of those funds would be needed to pay administrative costs of setting up the program. Once the program is in place, current law allows the ERS to assess an administrative fee on participating districts. This fee authority would be transferred to the TRS.

**ISSUE 6: Should the current statutory limitations on the investment of the Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOSRF) be removed to allow the fund to be invested in stocks?**

## **BACKGROUND**

The LECOSRF is a fund administered by the ERS which is designed to supplement the regular state employee retirement benefits for law enforcement and custodial officers of the state. Eligible members covered by LECOSRF include employees of the Texas Department of Criminal Justice whose jobs require regularly planned contact with inmates of state institutions, and commissioned law enforcement officers of the Texas Department of Public Safety, the Texas Alcoholic Beverage Commission, and the Texas Department of Parks and Wildlife. At the end of fiscal year 1991, there were 23,234 active members of these agencies that would be eligible to retire with the LECOSRF supplement. Retirement benefits of eligible members are similar to regular state employees. They receive two percent of their highest 36 months salary for every year of service credit. However, because they are eligible for supplemental benefits from the LECOSRF, they receive an additional amount on top of their standard state retirement.

The program is funded by a portion of the state motor vehicle inspection fees and investment earnings. The state contributes \$3.75 from the motor vehicle inspection fee on each new vehicle inspected and \$2.25 from the motor vehicle inspection fee on each renewal inspection. In fiscal year 1991, the LECOSRF received about \$27 million from these fees. As of August 31, 1991, the fund was paying benefits to 1,220 retirees. As of the same date, the fund had a book value of about \$263 million.

Currently, the Texas Government Code limits investing the funds of the LECOSRF to U.S. Government bonds, any security guaranteed by the U.S. Government, corporate bonds, and any short term security approved by the board of trustees. Similar restrictions were removed from the Employees Retirement Fund and the Judicial Retirement System - II fund by the 70th Legislature in 1987. As a result, portions of these funds are invested in stocks, which have traditionally earned higher rates of return than bonds. The restriction in place on the LECOSRF may be the reason why that fund has failed to match the rate of return of other ERS administered funds in three of the last five fiscal years, as shown below.

**ERF and LECOSRF Rates of Return - Fiscal Years 1987-1991**

Fund	1987	1988	1989	1990	1991
ERF	12.34%	11.35%	9.42%	9.31%	10.08%
LECOSRF	10.12%	9.58%	9.60%	9.53% —	9.46%

**CONCLUSION**

The rate of return received by investment of the LECOSRF over the last five years is less than other ERS-managed funds. The difference is due to the greater statutory limitations on the types of investments available to the fund.

**POLICY OPTION**

- **Eliminate the statutory restrictions on the types of investments available to the LECOSRF to maximize the fund's rate of return.**

Allowing the LECOSRF to participate in stock investments will allow it to access a type of investment which traditionally has a higher rate of return than the securities in which it has been allowed to invest.

**BENEFITS**

- ▶ **Removing the current investment restrictions would allow the system to maximize its rate of return for the LECOSRF.**
  - According to agency estimates, if the restriction was not in place and the fund had performed like the unrestricted ERF, the LECOSRF would have added an additional 1.84 percent to its five-year average rate of return. This would have meant an additional \$6.1 million dollars in earnings by the fund from 1987 to 1991. The extra funds would increase the financial soundness of the fund and perhaps allow for an increase in benefits for retirees in the future.
- ▶ **Eliminating the restrictions would give the ERS more flexibility in carrying out its fiduciary responsibilities to safely earn as much as possible for the fund.**
  - Removing the restriction on the LECOSRF would give the ERS more flexibility in its investment options for the LECOSRF, and make it similar to the ERF and JRS-II fund. Since the agency has not abused the same flexibility in managing

these two funds, there is no reason to prevent them from having similar flexibility in managing the LECOSRF.

### **DRAWBACKS**

- ▶ **Investments in stocks may not provide as great a protection of the initial investment.**
  - Because stock prices fluctuate, there is no guaranteed return on an investment, only a purchase of equity in a company. If the price of a purchased stock goes down, when it is sold, the fund will lose money. This is not the case with bonds. Bonds are essentially a contract to lend money at a given interest rate, for a particular period of time. Despite the price fluctuations of bonds, the return on the investment at the end of the loan period has already been determined, providing that the bond is held until maturity.
- ▶ **Even with the statutory restriction in place, the LECOSRF outperformed the other system's funds in two of the last five years.**
  - In 1989 and 1990 the LECOSRF had an average rate of return two-tenths of one percent higher than the Employees Retirement Fund. There is nothing to indicate that this will not occur over longer periods of time in the future. If this is the case, that portion of the fund invested in stocks would not be earning the maximum rate of return.

### **FISCAL IMPACT**

Based on the performance of the Employees Retirement Fund since similar restrictions were removed in 1987, the LECOSRF could earn in the area of \$1.2 million more each year if the restriction on stock purchase is removed. However, there is no assurance of higher earnings.



**ISSUE 7: Should the ERS be authorized to treat the retirement funds it manages as one fund for investment purposes only?**

**BACKGROUND**

The ERS is responsible for investing three retirement funds: the Employees Retirement Fund (ERF) which is valued at about \$7.3 billion; the Law Enforcement and Custodial Officers' Supplemental Retirement Fund (LECOSRF) which is valued at about \$263 million; and the Judicial Retirement System Plan II Fund (JRS-II) which is valued at about \$9 million. The ERS investment division is responsible for investing the assets of the funds. The division attempts to make investments that result in the greatest earnings at the lowest risk and cost. All investments must be consistent with general investment policies established by the board of trustees.

Each of the ERS managed funds are administered by the investment division, but are invested separately. The ERS does not have the clear authority to mix money from the funds together when making an investment. Although each fund may have investments in the same company, the analysis done in choosing the stock, the actual purchase of the stock and the accounting for each fund are completely separate. This is unlike authority granted to banks under the Texas Trust Code. The trust code specifically permits some banks to create a common fund into which a bank is permitted to invest the various trust funds which it administers.

The ERS board has established a policy that limits the amount that the system or an individual fund may have invested in any one company. This helps prevent the system's funds from becoming too tied to the fortunes of one particular company. The result is that each fund is diversified among a variety of companies. The ERF and LECOSRF are of a sufficient size so that they can be managed and diversified by the ERS although they are administered separately. However, the JRS-II fund is only valued at \$9 million and to diversify the fund's holdings in accordance with board's investment criteria, the ERS would have to purchase small quantities of a large number of companies. Instead, the ERS invests the JRS-II fund in mutual funds, which themselves are made up of the holdings of a large number of stocks. This method provides the diversification necessary to meet the board's guidelines and ensure protection of the assets of the fund.

One of the characteristics of mutual funds is that they charge management fees for investments made with the mutual fund. Management fees for JRS-II are typically about one percent of assets invested. This means that the JRS-II fund pays about \$90,000 each year in mutual fund investment fees. As the fund grows in value the amount paid in fees will rise.

The LECOSRF is managed directly by the ERS and does not pay management fees. However, the administrative costs of that fund are higher, as a percentage of assets, than those of the ERF. This is due to the fact that the ERF simply has more assets over which costs are distributed. The administrative costs of the LECOSRF are 0.06 percent of the fund while those of the ERF are 0.03 percent.

## CONCLUSION

The costs of the investment of the JRS-II fund and the LECOSRF, as a percentage of the size of the funds, are higher than the costs of managing the investment of the ERF. The ERS, however, does not have direct authority to merge the assets of the JRS-II fund, the LECOSRF and the ERF for investment purposes. As a result, the current method of administering the system's retirement funds separately does not allow the ERS to use the least costly methods to diversify and manage all of the retirement funds.

## POLICY OPTION

- **The statute should be amended to authorize the ERS to combine the ERF, the LECOSRF and the JRS-II funds for the purposes of investment only.**

If these funds were combined, assets from each fund would be placed into one joint account. The joint account would then be invested on the securities and fixed income markets in accordance with the policies of the ERS. Any profit realized by the joint account would then be distributed to the retirement funds in proportion to the amount each fund contributed to the joint account. Likewise, any losses the joint account realizes would be distributed among the three funds in proportion to the amount initially invested by each fund into the joint account. In all other aspects the funds would be separate. Benefits would still be paid from each fund, and only to those members who are qualified to receive benefits from each fund. For example, the LECOSRF would still only pay for supplemental benefits to eligible custodial and peace officers.

## **BENEFITS**

- ▶ **The JRS-II fund would be properly diversified at the lowest cost to the fund.**
  - In fiscal year 1991, the ERS paid about \$90,000 in fees to mutual funds for management of the \$9 million JRS-II fund. This represents about one percent of the assets of the fund. In comparison, the ERF, which is valued at about \$7.3 billion, had management costs of about \$2,190,000. This represents about 0.03 percent of the assets of the fund.

- If the JRS-II fund had been merged with the other funds for investment purposes, the management costs would have been similar to the ERF. Costs would have been closer to \$2,700 for fiscal year 1991, resulting in savings of about \$87,300.
- ▶ **The LECOSRF would realize savings from a reduction in management costs.**
  - The LECOSRF, valued at about \$263 million, had management costs of \$149,300 or about 0.06 percent of the fund in fiscal year 1991. In comparison, the ERF, which is valued at about \$7.3 billion, had management costs of about \$2,190,000. This represents about 0.03 percent of the assets of the fund.
  - If the LECOSRF had been merged with the other funds for investment purposes, the management costs would have been similar to the ERF. Costs would have been closer to \$78,900 for fiscal year 1991, resulting in savings of about \$70,400.
- ▶ **The process to determine purchases of stock would be simplified due to having to consider the effects of the purchase on only one fund.**
  - Currently, internal portfolio managers at the ERS must make separate decisions as to the desirability of possible stock purchases for each ERS retirement fund. If the funds are combined for investment purposes, the internal portfolio managers would only have to take into consideration the effects of the purchase on one fund.
- ▶ **The merging of funds could take place without additional costs. The ERS indicates that it is already equipped to perform the record keeping necessary to properly allocate asset ownership and income distribution to each fund.**

#### **DRAWBACKS**

No drawbacks to combining the ERS managed funds for investment purposes were identified.

#### **FISCAL IMPACT**

Savings of about \$157,700 per year are expected from combining the ERF, LECOSRF and JRS-II for investment purposes. Savings are based on the removal of fees paid to mutual fund companies for investment of JRS-II assets and the reduction in administrative expenses for the LECOSRF. The JRS-II fund would save about \$87,300 per year and the LECOSRF is expected to save about \$70,400 per year. The merger of funds for investment purposes

would not require the purchase or development of any additional software, and would be absorbed into the workload of the current investment staff without detrimental effects.

Year	Savings to the JRS-II Fund and LECOSRF
1994	\$157,700
1995	\$157,700
1996	\$157,700
1997	\$157,700
1998	\$157,700

**ISSUE 8: Should the Optional Retirement Program be abolished?**

**BACKGROUND**

The Optional Retirement Program (ORP) was created by the legislature in 1976 to provide faculty members and administrators in higher education an alternative to the Teacher Retirement System. The purpose of the program was to provide younger and more mobile higher education employees with the ability to establish a retirement program that was more portable so that they could take their accumulated benefits with them, after a limited vesting period, as they pursued their careers from one state to another. Currently, certain eligible higher education employees may choose to participate in either the ORP or the TRS.

The TRS retirement program is a *defined benefit plan* which promises a specific level of benefits to its members when they retire. The amount of benefit is based on the employee's length of service and final average salary. The retirement program is funded by state and active member contributions. The state contribution to the program was 7.31 percent and the member contribution was 6.4 percent in fiscal year 1991. Employee and state contributions are deposited into a large trust fund. The TRS manages and invests the fund. Members are not eligible for retirement benefits until they have worked five years and cannot receive such benefits until they reach retirement age. All public school, college, and university employees become members of the retirement program automatically upon employment unless certain eligible members choose to join the ORP. In fiscal year 1991, there were 520,617 active members and 118,305 retirees.

In contrast, the Optional Retirement Program is a *defined contribution plan* which provides benefits to its members based solely on the accumulated contributions and interest earned in a member's account. The ORP is funded by state and member contributions. In 1991, the state contribution to the ORP was reduced from 8.5 to 7.31 percent and the member contribution was maintained at 6.65 percent. The member is responsible for the investing and performance of the fund. ORP members are able to withdraw all accumulated funds in the members' account after one year of service. Currently, those eligible to participate in the ORP include faculty members, administrators who are responsible for teaching and research, administrative staff of the coordinating board, professional librarians, presidents, vice presidents, chancellors, vice chancellors, and other professional staff that are generally recruited by advertising in national publications or at national association meetings. The number of participants in the ORP totalled 34,706 in 1991.

Over the years, questions have been raised about the structure of the ORP in relation to the standard TRS benefit plan. Contacts with state employee associations and certain education interest groups indicated continuing concerns about the ORP. One concern is that ORP is seen as inequitable compared with the TRS retirement plan because ORP members are able

to withdraw all accumulated funds in the members' account after one year of service. This withdrawal includes both state and member contributions and the interest earned on those contributions. In contrast, members of the TRS are not eligible for retirement benefits until they have worked five years and cannot actually receive benefits until they reach retirement age. In addition, if a TRS member leaves state employment and withdraws the funds before they reach retirement age, only contributions made by the individual plus five percent interest on those funds can be withdrawn. The TRS member who withdraws early forfeits the state contribution, any interest earned on the state contributions, and any interest earned on the member contributions in excess of five percent. Another concern about equity between the two programs is that the ORP members are able to receive up to a 1.19 percent supplement to their state contribution rate from the universities. The TRS members have no access to similar supplements from their employers.

Concerns have also been raised about the overall need for the ORP now that the number of years required for vesting under the TRS has been reduced. Under TRS, a vested member is one who has worked for a certain time period within the system and is therefore eligible for retirement benefits upon reaching retirement age. When the ORP was first created, the vesting period for the TRS was 10 years, but has since been reduced to 5 years. The reduced TRS vesting period makes the ORP only necessary for employees working less than five years. A final concern regarding the ORP is the possibility that the ORP members will hold the state liable if the insurance companies that invest the funds of the ORP members fail. This situation has occurred in other states.

## CONCLUSION

The structure of the ORP is inequitable when compared with the TRS retirement plan in terms of the vesting period, account withdrawal abilities, and the amount of contributions received. Concerns have been raised about the need for this special program to provide a limited group of employees with benefits beyond those offered to other members of TRS, particularly now that the vesting period for the TRS has been reduced to five years.

## POLICY OPTION

- **The statute should be amended to eliminate the Optional Retirement Program. Current ORP members would be allowed to remain in the ORP but no further enrollment would be permitted.**

Under this approach the university employees currently enrolled in the ORP would continue in the program, with the state continuing to provide its share of contributions to the members' accounts. Employees who are currently participating in the program will not lose their benefits or be forced into switching to the TRS retirement program. However, no

further enrollment in the ORP would be allowed after September 1, 1993 if legislation affecting this change is adopted.

## **BENEFITS**

- ▶ **Eliminating the ORP would ensure that all employees of public schools, colleges, and universities receive an equal level of benefits from the state.**
  - The purpose of the ORP allows Texas to compete nationally for high quality university personnel. However, there are no comparable benefits or unique incentives to attract high quality public school teachers to Texas.
  - The ORP receives a higher level of state support in relation to the TRS program because of a difference in the funding structure of the two programs. The ORP members and TRS members receive a state contribution of 7.31 percent. However, TRS must fund both current and future benefits. Of the 7.31 percent state contribution rate, it is estimated that 5.95 percent finances current benefits and the remaining 1.36 percent goes toward financing future promised benefits. Because the ORP is a defined contribution plan, there are no future benefits to be financed. At retirement or when the member terminates employment with the university, ORP members receive benefits based solely on the accumulated contributions and interest in their account, with no commitment beyond that. According to a 1991 report by the Texas Performance Review, to be comparable, the state should only be funding ORP at a rate of 5.95 percent for current benefits. Although the 72nd Legislature reduced the state contribution rate to ORP from 8.5 percent to 7.31 percent, the state contribution amount received by the ORP still exceeds the 5.95 percent needed to fund current benefits.
  - ORP members are also eligible to receive additional contributions from their employers beyond the set state contribution. The 72nd Legislature reduced the state contribution to ORP but authorized universities and colleges to contribute up to 1.19 percent of salary to the ORP members' accounts to bring the state contribution rate back up to the previously authorized rate of 8.5 percent. A survey by the Texas Higher Education Coordinating Board shows that all the senior colleges and universities and half of the junior colleges have opted to supplement the standard state contribution rate. Responses show that this has resulted in competition among the state institutions to provide the highest benefits possible. The majority of the institutions further responded that the supplement was made in lieu of providing other increased benefits and that had they not

supplemented the state contribution rate they could have afforded salary increases.

- ▶ **The reduction of the vesting period at the TRS to five years has reduced the need for this special program.**
  - At the time the ORP was created, a person had to be employed at least 10 years before being eligible for retirement benefits. However, in 1989, the TRS vesting period was reduced to five years. This has reduced the need for the Optional Retirement Program to those persons who terminate employment with the university with less than five years of service.
- ▶ **Eliminating the ORP would ensure against any potential problems in the future that could arise if people's retirement funds under the ORP are lost or insufficient to meet their needs.**
  - Under the ORP, the performance of the member's investments and determining the stability of the insurance companies is solely the member's responsibility. Recently, six large insurance companies have gone insolvent.
  - In Texas, the Guaranty Association is a program set up by state law to cover losses in bankrupt companies. The program covers up to \$100,000 for one or more annuity contracts issued to an individual. However, many annuities exceed the \$100,000 coverage and any accumulated funds in excess of this amount would not be protected.

#### **DRAWBACKS**

- ▶ **The ORP has proven to be useful for short-term faculty and this option would eliminate it.**
  - Faculty who serve less than five years would not be eligible to vest under the TRS and would only have access to their member contribution plus five percent interest upon termination. Under the ORP, members who terminate after one year have access to the entire accumulation in their account, plus any interest from that account.
- ▶ **Eliminating the ORP would reduce Texas' ability to compete for quality faculty.**
  - At least 30 other states have a program similar to Texas' ORP and others, such as New Mexico, are in the process of implementing an ORP.

- Texas universities depend on the ORP to attract quality faculty because, compared with other states, Texas ranks very low on salaries paid to university faculty.
- ▶ **The inequities that exist between the TRS and ORP do not justify eliminating the program.**
- The original purpose of the ORP was to attract certain quality university faculty by providing benefits that were more attractive than the benefits offered by standard retirement plans. Although the structure of the ORP is inequitable when compared with the TRS benefit plan, it has fulfilled its original objectives.

### **FISCAL IMPACT**

It is estimated that this option would result in savings to the state; however, no actual fiscal estimate is available at this time. It would also result in a savings of local funds for the colleges and universities currently supplementing the state contribution for employees enrolled in ORP. According to the Higher Education Coordinating Board, the statewide costs to colleges and universities to provide this supplement in fiscal year 1991 was \$14,876,019.



**ISSUE 9: Should the state contribution rate to the Public School Retired Employees Group Insurance Program (TRS-Care) be adjusted each biennium to reflect the financing needs of the program?**

## **BACKGROUND**

The Texas Public School Retired Employees Group Insurance Program (TRS-Care) was created in 1985 by the 69th Legislature. The program provides a basic level of health insurance coverage to retirees at no cost, with the option to purchase a higher level of insurance coverage. The program is available to all eligible Texas public school retirees, regardless of where they reside. Eligible retirees are those who have ten years credited TRS service and are not eligible to participate under the state employee or the higher education group insurance plans.

TRS-Care was established to provide eligible public school employees health insurance coverage upon retirement. The need for this program was raised through a study by the TEA in 1985 that showed that less than half of the school districts continued health insurance coverage for their employees after retirement and half of those did not cover the retirees beyond the age of 65. Active members automatically become TRS-Care members upon retiring unless they opt out. In fiscal year 1991, 90 percent of the TRS retirees who were eligible to participate in TRS-Care were covered under the program.

The TRS-Care program began providing coverage to TRS retirees on September 1, 1986. Funding for the program is provided by the state and active TRS member contributions. Retirees also contribute if they choose to pay for optional insurance coverages. Initially, active TRS members contributed 0.25 percent of their salary to the fund and the state contributed 0.35 percent. The state's contribution rate was statutorily increased to 0.50 percent in 1989. The statute also requires that the state contribution rate be twice the member's contribution rate.

The cost to deliver TRS-Care health insurance coverage continues to rise as medical costs escalate. Health insurance claims costs are increasing at about 18 to 20 percent a year. One way to manage increasing medical costs is to utilize cost containment measures. The TRS is addressing cost containment through development of a managed care network. The network will consist of any physician and hospital throughout the state who, by contract, agree to established fees for service and other controls that are aimed at reducing unnecessary hospitalization and treatment. The TRS will be in exclusive control of this network. The network is expected to be completely implemented by September 1, 1994. The TRS estimates that this network will reduce insurance claim costs by \$3 million or two percent initially in fiscal year 1994. Savings are projected to increase even more in later years.

Initial TRS-Care fund projections made in 1985 indicated that the plan would be solvent under the current financing scheme through fiscal year 1995. The implementation of the managed care network and other cost management techniques have extended the solvency of the fund through fiscal year 1996. However, increased state and member contributions will be necessary to extend the solvency of TRS-Care beyond fiscal year 1996.

The TRS has proposed funding TRS-Care on a long-term basis that would extend the solvency of the program through the year 2000 by increasing the state contribution rate to 0.85 percent and the member contribution rate to 0.425 percent beginning in September 1994. The TRS proposal would require an additional \$42.6 million in appropriations for the 1994-1995 biennium over the current biennium. However, current projections indicate that the legislature will be considerably short of revenue to provide even the current levels of state services.

## CONCLUSION

At the current state and member contribution rates, the TRS estimates that the TRS-Care program will only remain solvent through fiscal year 1996. The TRS has proposed a long-term plan that ensures solvency of TRS-Care through fiscal year 2000, by requesting legislative approval in 1993 for increases in the state and member rates, to begin in fiscal year 1994. However, the legislature may not have sufficient funds available to establish the TRS proposal in fiscal year 1994.

## POLICY OPTION

- **The statute should be amended to:**
  - **establish a range of 0.50 to 1.00 of salary for the state contribution rate to TRS-Care;**
  - **authorize adjustments to the state contribution rate to TRS-Care through the appropriations process to reflect the financing needs of the program for that biennium; and**
  - **require that the active member contribution rate to TRS-Care be adjusted by the TRS to be half of the state contribution rate.**

Under this approach, the legislature would set the state contribution rate every two years through the appropriations process. The legislature, with the assistance of the TRS, would examine the levels of funding needed to ensure that TRS-Care is financially sound for the next two years. The appropriation for TRS-Care would be based on the result of that examination.

The TRS members' contribution rate would also be adjusted every two years to reflect one-half the state contribution rate set by the legislature. This requirement ensures the continuation of the current funding ratio between the state and members' contribution rates.

## BENEFITS

- ▶ **Increased funding for TRS-Care for the 1994-1995 biennium would not be required.**
  - Currently, TRS-care is solvent through fiscal year 1996. Therefore, it is not essential to provide additional funding to the program until the 1996-1997 biennium. This option allows the legislature to delay providing additional funding for TRS-Care, given the revenue shortfall that is anticipated for the upcoming biennium.
- ▶ **The legislature would have the flexibility and control to adjust the state contribution to TRS-Care as needed.**
  - Currently, the state is required by statute to contribute 0.50 percent of salary to the TRS-Care program each year. The state must contribute this amount even during years of high investment returns and/or poor economic times.
  - When investment returns are high, the TRS-Care may be able to afford a reduction in the state contribution. The reduction in contributions would allow the state to use the extra funds for other state programs. With the contribution rate set in statute, the legislature does not have the flexibility to do this now.
  - As a comparison, the constitution requires the state contribution rate to the TRS retirement program to be within a certain range. The legislature has the flexibility to adjust the state contribution to the retirement program as long as the rate is no less than 6 percent but no more than 10 percent. In each biennium since 1981, the legislature has adjusted the state contribution rate to the retirement program.
- ▶ **Biennial funding of TRS-Care would match the way the state's employee health insurance program is funded.**
  - The ERS health insurance program for state employees receive appropriations every two years based on the financial needs of the programs. The state contribution rate for the ERS health insurance program is set through the appropriations act. Before the legislative

session, the ERS estimates the funding necessary for providing health benefits and keeping the program fiscally sound. After analysis and adjustment by the Legislative Budget Board and the legislature, the funds are set out in the appropriations act.

- The biennial funding method has worked well for the retirement and health insurance programs. No problems were identified resulting from this financing scheme.

#### **DRAWBACKS**

- ▶ **Funding TRS-Care each biennium, instead of on a long-term basis, would be more costly to the state in the long run.**
  - The TRS states that delaying the additional funding to TRS-Care to fiscal years 1996-97 will be more expensive to the state in the long run. They state that while this change will cost more initially to the state to increase its contribution to TRS-Care from 0.50 to 0.85 percent of salary beginning in fiscal year 1994, that these increases will keep the program solvent through to fiscal year 2000. This is tied to the fact that TRS would invest the additional funds in the initial years, earning interest that would help delay the need to raise the rates in later years. The TRS states that funding it on a biennial basis will require increases in the rate to as much as 2.00 percent of salary by fiscal year 2001.
- ▶ **Funding TRS-Care on a biennial basis would take away from the agency the ability to plan and project costs beyond the current biennium.**
  - The TRS states that not knowing what the state contribution rate will be from year to year will make their management and planning for the program more difficult. They also state that funding the program on a biennial basis could result in assets not being available to meet unexpected contingencies.

#### **FISCAL IMPACT**

There would be no fiscal impact of this option in fiscal years 1994, 1995 and 1996. However, in fiscal years 1997 and 1998, it is estimated that additional funding beyond the current state contribution rate of 0.50 percent of salary would be necessary to keep the program solvent. The legislature would determine how much the state contribution rate would have to be increased based on the financial needs of the TRS-Care program at that time.

**ISSUE 10: Should a mechanism for an automatic cost-of-living adjustment (COLA) that provides a predictable annual benefit increase for TRS retirees be established?**

## **BACKGROUND**

Upon retirement under the TRS system, a person receives a fixed monthly benefit based on age and years of service. However, over time the benefit is often not sufficient to keep pace with inflation and rising consumer costs. In response, cost-of-living adjustments have been implemented by many public systems nationwide to address this problem.

The Texas Legislature has also approved numerous cost-of-living increases for retirees over the years. These increases are not required to be provided on a regular schedule but have been provided on an "ad hoc" basis. The ad hoc benefit increases have often been targeted to provide retirees greater benefit increases the longer a person has been retired, but are not guaranteed each year.

Before 1981, ad hoc benefit increases were funded entirely through state appropriations. Since 1984, 50 to 60 percent of these increases have been funded by TRS investment earnings, 20 percent by state appropriation, with the remaining funds provided by member contributions. The cost to implement these ad hoc increases has been increasing over time due to inflation, the level of benefits provided and an increasing number of retirees. For example, a 1971 ad hoc increase that provided for a 10 percent increase in the monthly retirement benefits of all TRS retirees cost \$87 million. However, a 1991 ad hoc increase that provided for a one percent increase in the monthly retirement benefits for each year of service for all TRS retirees who retired before May 1989 cost \$657 million. The legislature's strategy in providing ad hoc increases has been to bring the benefit levels of older retirees up to parity with more recent retirees. The strategy has also attempted to increase all members' retirement benefits as inflation has increased.

Another approach to helping retirees to keep up with inflation is to guarantee annual benefit increases through an "automatic" cost-of-living adjustment. Automatic COLAs occur at regular intervals, are predictable, and increase at rates which keep pace with inflation. Historically, automatic COLAs have been actuarially expensive benefit increases, although some claim that, in the future, as retirees outnumber active members, automatic COLAs will be less expensive than providing ad hoc increases to retirees. A majority of states provide some type of COLA. According to a study by the firm of Deloitte and Touche (1991), eighteen states provide a COLA on an ad hoc basis and thirteen states base the COLA on changes in the Consumer Price Index (CPI).

Texas has not opted to authorize an automatic COLA. A proposal for an automatic COLA was introduced in House Bill 7 during the 72nd Regular Session but failed in a conference committee after passing both the House and Senate. The bill proposed that 75 percent of the TRS' actuarial gains through fiscal year 1997 be set aside in a COLA Reserve Account. During 1998, the TRS board would have determined if sufficient funds had accumulated to implement an automatic COLA and the nature of the COLA. Under the bill, the TRS board would have had the authority to postpone the implementation of the automatic COLA until sufficient funds had accumulated to keep the TRS funding period within the required 31 years. The funding period refers to the time needed for the TRS to pay off its future liabilities. A funding period in excess of 31 years would put the TRS at risk of becoming actuarially unsound. Once sufficient funds had accumulated, the automatic COLA would have provided for an annual increase of one-half the annual percentage increase in the Consumer Price Index, not to exceed three percent. Future funding for the automatic COLA would come from investment gains earned from the COLA Reserve Account. Under House Bill 7, once the automatic COLA was implemented, there was no provision that would prevent the implementation of the COLA in any year if, for that year the TRS funding period exceeded 31 years.

## CONCLUSION

In general, fixed retirement benefits cannot keep pace with inflation and cost-of-living increases over time. Ad hoc benefit increases have been used to bring groups of retirees closer to a level equal with inflation. However, ad hoc increases can be costly and do not provide retirees with a predictable means of dealing with increasing costs of living and inflation.

## POLICY OPTION

- **Authorize the TRS to establish a mechanism in rules that would provide for an automatic COLA, as proposed in House Bill 7 of the 72nd Regular Session.**

This option would allow the TRS to set aside 75 percent of TRS investment gains into a COLA Reserve Account each year until sufficient funds have accumulated to implement an automatic COLA. The option prevents implementation of the automatic COLA if it would cause the TRS funding period to exceed 31 years. Once sufficient funds have accumulated, the TRS board of trustees will decide on a method to compute the cost-of-living adjustment and when the first cost-of-living adjustment will be provided. Once the automatic COLA is in place, it would provide for an annual increase of one-half the annual percentage increase in the Consumer Price Index, not to exceed three percent. Setting a maximum cost-of-living adjustment at three percent of the CPI would ensure that providing the COLA during years of low actuarial gains to the retirement fund would not

cause the TRS funding period to exceed 31 years. The automatic COLA would be limited to retirees receiving service retirement benefits and members receiving disability benefits who have at least 10 years of TRS service.

## BENEFITS

- ▶ **An automatic COLA would help provide retirees with predictable benefit increases and permanent protection against the rising cost of inflation.**
  - With a guaranteed automatic cost-of-living benefit increase each year, retirees who live predominantly off their TRS retirement benefits would not have to worry if they will receive an increase from year to year.
  - The automatic COLA as set out here provides for an annual increase of one-half the Consumer Price Index, not in excess of three percent. This increase would help keep retirement benefits more in line with inflation.
  - Ad hoc increases do not provide a systematic and predictable approach for keeping up with the cost-of-living. In contrast, the defined nature of a COLA gives a consistent means of keeping up with inflation and knowing what the increase in benefits will be.
- ▶ **Biennial approval by the legislature for an automatic COLA would not be necessary.**
  - Unlike ad hoc increases, automatic COLAs occur each year that the CPI increases so it would not be necessary for the legislature to consider the need for a benefit increase each biennium.

## DRAWBACKS

- ▶ **The legislature would have difficulty providing ad hoc increases during the period when the funds for the automatic COLA are being set aside.**
  - Setting aside 75 percent of actuarial gains each year to build a COLA reserve fund would prevent the legislature from providing ad hoc benefit increases of the size that have been provided in the past, unless the state contribution rate were increased.
- ▶ **The legislature may have to increase the state contribution rate during the period when funds for the automatic COLA are being set aside.**

- Past actuarial gains have allowed the TRS funding period to decrease, which in turn, has allowed the state contribution rate to be reduced. Transferring 75 percent of these actuarial gains to the COLA reserve account would leave only 25 percent of the gains to be used by the state to lower the state contribution rate. If 25 percent of actuarial gains were used for an ad hoc increase, no actuarial gains would remain to use toward lowering the state contribution rate.
- ▶ **Providing an automatic COLA each year without adequate safeguards could jeopardize the actuarial soundness of the TRS.**
  - Under House Bill 7, once the automatic COLA was implemented, there would be no provision that would prevent the implementation of the COLA in any year if, for that year the funding period were to exceed 31 years. The actuarial soundness of the system is at risk when the funding period exceeds 31 years.
- ▶ **TRS retirees may experience unreasonable delays in receiving their first cost-of-living adjustment.**
  - As provided in House Bill 7, the board would be authorized to set the deferral period, which is the time between a member's retirement and the beginning of the COLA, at whatever period of time would ensure the soundness of the fund. For example, the TRS active members might have to wait from 10 to 15 years after they retire to receive their first cost-of-living adjustment.

#### FISCAL IMPACT

According to the LBB actuarial analysis of House Bill 7, no estimate of the fiscal impact in future years of this change could be determined. However, according to the LBB actuary, if an automatic COLA had been implemented in fiscal year 1991, based on investment gains from fiscal year 1986 through fiscal year 1990, the additional cost to the state for fiscal year 1991 would have been \$151.8 million. This cost includes an increase in the state contribution from 7.65 percent to 9.03 percent that would have been necessary to keep the TRS funding period below 31 years. This analysis took into account other benefit improvements and state contribution rate reductions that actually occurred during the 1986-90 period.

<b>Employees Retirement System of Texas</b>			
<b>APPLIED</b>	<b>MODIFIED</b>	<b>NOT APPLIED</b>	<b>ACROSS-THE-BOARD RECOMMENDATIONS</b>
			<b>A. GENERAL</b>
	X		1. Require public membership on boards and commissions.
X			2. Require specific provisions relating to conflicts of interest.
X			3. Provide that a person registered as a lobbyist under Article 6252-9c, V.A.C.S., may not act as general counsel to the board or serve as a member of the board.
X			4. Require that appointment to the board shall be made without regard to race, color, disability, sex, religion, age, or national origin of the appointee.
	X		5. Specify grounds for removal of a board member.
*			6. Require the board to make annual written reports to the governor and the legislature accounting for all receipts and disbursements made under its statute.
X			7. Require the board to establish skill-oriented career ladders.
X			8. Require a system of merit pay based on documented employee performance.
	X		9. Provide for notification and information to the public concerning board activities.
		X	10. Place agency funds in the treasury to ensure legislative review of agency expenditures through the appropriation process.
X			11. Require files to be maintained on complaints.
X			12. Require that all parties to formal complaints be periodically informed in writing as to the status of the complaint.
X			13. Require development of an E.E.O. policy.
X			14. Require the agency to provide information on standards of conduct to board members and employees.
X			15. Provide for public testimony at agency meetings.
X			16. Require that the policy body of an agency develop and implement policies which clearly separate board and staff functions.
X			17. Require development of accessibility plan.
		X	18. Place agency under the state's competitive cost review program.

\* Already in law -- no statutory change needed.

\*\* Already in law -- requires updating to reflect standard ATB language.

<b>Employees Retirement System of Texas (cont.)</b>			
APPLIED	MODIFIED	NOT APPLIED	ACROSS-THE-BOARD RECOMMENDATIONS
			<b>B. LICENSING</b>
		X	1. Require standard time frames for licensees who are delinquent in renewal of licenses.
		X	2. Provide for notice to a person taking an examination of the results of the exam within a reasonable time of the testing date.
		X	3. Provide an analysis, on request, to individuals failing the examination.
		X	4. Require licensing disqualifications to be: 1) easily determined, and 2) related to currently existing conditions.
		X X	5. (a) Provide for licensing by endorsement rather than reciprocity. (b) Provide for licensing by reciprocity rather than endorsement.
		X	6. Authorize the staggered renewal of licenses.
		X	7. Authorize agencies to use a full range of penalties.
		X	8. Specify board hearing requirements.
		X	9. Revise restrictive rules or statutes to allow advertising and competitive bidding practices which are not deceptive or misleading.
		X	10. Authorize the board to adopt a system of voluntary continuing education.

\* Already in law -- no statutory change needed.

\*\* Already in law -- requires updating to reflect standard ATB language.

<b>Teacher Retirement System of Texas</b>			
APPLIED	MODIFIED	NOT APPLIED	ACROSS-THE-BOARD RECOMMENDATIONS
			<b>A. GENERAL</b>
	X		1. Require public membership on boards and commissions.
X			2. Require specific provisions relating to conflicts of interest.
X			3. Provide that a person registered as a lobbyist under Article 6252-9c, V.A.C.S., may not act as general counsel to the board or serve as a member of the board.
X			4. Require that appointment to the board shall be made without regard to race, color, disability, sex, religion, age, or national origin of the appointee.
	X		5. Specify grounds for removal of a board member.
X			6. Require the board to make annual written reports to the governor and the legislature accounting for all receipts and disbursements made under its statute.
X			7. Require the board to establish skill-oriented career ladders.
X			8. Require a system of merit pay based on documented employee performance.
	X		9. Provide for notification and information to the public concerning board activities.
		X	10. Place agency funds in the treasury to ensure legislative review of agency expenditures through the appropriation process.
X			11. Require files to be maintained on complaints.
X			12. Require that all parties to formal complaints be periodically informed in writing as to the status of the complaint.
X			13. Require development of an E.E.O. policy.
X			14. Require the agency to provide information on standards of conduct to board members and employees.
X			15. Provide for public testimony at agency meetings.
X			16. Require that the policy body of an agency develop and implement policies which clearly separate board and staff functions.
X			17. Require development of accessibility plan.
		X	18. Place agency under the state's competitive cost review program.

\* Already in law -- no statutory change needed.

\*\* Already in law -- requires updating to reflect standard ATB language.

<b>Teacher Retirement System of Texas (cont.)</b>			
APPLIED	MODIFIED	NOT APPLIED	ACROSS-THE-BOARD RECOMMENDATIONS
			<b>B. LICENSING</b>
		X	1. Require standard time frames for licensees who are delinquent in renewal of licenses.
		X	2. Provide for notice to a person taking an examination of the results of the exam within a reasonable time of the testing date.
		X	3. Provide an analysis, on request, to individuals failing the examination.
		X	4. Require licensing disqualifications to be: 1) easily determined, and 2) related to currently existing conditions.
		X X	5. (a) Provide for licensing by endorsement rather than reciprocity. (b) Provide for licensing by reciprocity rather than endorsement.
		X	6. Authorize the staggered renewal of licenses.
		X	7. Authorize agencies to use a full range of penalties.
		X	8. Specify board hearing requirements.
		X	9. Revise restrictive rules or statutes to allow advertising and competitive bidding practices which are not deceptive or misleading.
		X	10. Authorize the board to adopt a system of voluntary continuing education.

\* Already in law -- no statutory change needed.

\*\* Already in law -- requires updating to reflect standard ATB language.

**EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
TEACHER RETIREMENT SYSTEM OF TEXAS**

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