

A Report on

The Fire Fighters' Pension Commissioner's Texas Statewide Emergency Services Personnel Retirement Fund for Fiscal Year 2004

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**State
Auditor's
Office**

**John Keel, CPA
State Auditor**

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Overall Conclusion

In our audit report dated December 15, 2004, we concluded that the basic financial statements of the Fire Fighters' Pension Commissioner (Commissioner) for the fiscal year ended August 31, 2004, were materially correct in accordance with accounting principles generally accepted in the United States of America.

We also issued a report on compliance and on internal control over financial reporting as required by auditing standards. Our procedures were not intended to provide an opinion on compliance with laws and regulations or to provide assurance on internal control over financial reporting. However, our procedures identified no instances of noncompliance with laws and regulations, and we noted no material weaknesses involving internal control over financial reporting.

Conducting our audit of the Commissioner's financial statements also enabled us to obtain additional information on other issues of legislative interest.

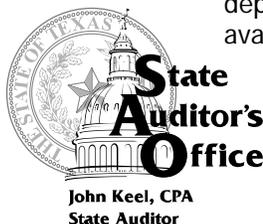
Background and Statutory Information

- The Commissioner provides retirement, death, and disability benefits to volunteer fire fighters. At the end of fiscal year 2004, the Commissioner's Texas Statewide Emergency Services Personnel Retirement Fund (Fund) had 7,994 members, including 1,557 retirees and beneficiaries.
- The Fund's retirement benefits paid in fiscal year 2004 ranged from \$8 to \$593 per month. The average payment was approximately \$88 per month.
- Texas Civil Statutes, Article 6243e.3, Section 1(6), define an actuarially sound pension system as a system for which the amount of contributions is sufficient to cover the normal cost and amortization of the unfunded prior-service cost in a period not to exceed 30 years.
- Texas Civil Statutes, Article 6243e.3, Section 2(d), require the State to contribute a sum necessary to make the Fund actuarially sound each year. However, statute requires that this contribution may not exceed one-third of the total of all contributions by fire department governing bodies in one year.

Other Issues of Legislative Interest

Although we noted no problems with the Commissioner's basic financial statements, for the second consecutive biennial valuation the actuary for the Texas Statewide Emergency Services Personnel Retirement Fund (Fund) has determined that the Fund is actuarially unsound. Current member benefits are not in jeopardy; however, based on the valuation the actuary made as of August 31, 2004, the Fund's financial health continues to decline. The following items demonstrate the Fund's financial condition:

- The Fund had a \$13,426,925 projected funding deficit (unfunded actuarial accrued liability) as of the end of fiscal year 2004.
- The Fund's actuary projects that the Fund's benefit payments will exceed fire department governing body contributions in fiscal year 2005, leaving no "surplus" available to amortize the projected funding deficit. When the cost of amortizing the



deficit over the statutory 30-year period is considered, the Fund had a contribution deficiency of \$1,163,758 as of August 31, 2004.

- Consistent with the Fund's actuary's five-year smoothing process, the Fund's actuarial valuation did not include \$2.1 million in net investment losses that occurred in prior fiscal years. The Fund must still recognize its prior investment losses during the next four years, which could increase the Fund's projected deficit.
- Because the Fund is actuarially unsound, Texas Civil Statutes require the State to make additional annual contributions of \$680,847 to restore the Fund's actuarial soundness as it is defined in statute. Additional annual contributions from other sources of \$482,911 are needed to make the fund actuarially sound.

In June 2004, the Commissioner requested \$604,992 and \$612,523 in emergency funding (for fiscal years 2003 and 2004, respectively) from the Office of the Governor. The Commissioner's Legislative Appropriations Request also contains an exceptional item request for \$675,307 and \$709,072 for fiscal years 2006 and 2007, respectively. The Commissioner is researching possible statutory changes that could help strengthen the Fund's financial position.

The Legislature may need to consider making other adjustments (such as changing eligibility requirements, modifying benefits, or adjusting other funding methods) to restore the Fund's actuarial soundness. In March 2004, the Fund's actuary estimated that the Fund would need to earn an annual investment return net of investment expenses of 19.37 percent for the next five years and then 8 percent thereafter to be able to amortize the projected funding deficit over the statutory 30-year period. The actuary did not believe that this was a realistic expectation and, therefore, concluded that solely increasing investment return would not restore the Fund's actuarial soundness. In addition, because pension benefits are directly tied to the contributions made, increasing contributions will result in increasing benefits, which may have a negative impact on the Fund's actuarial soundness.

In addition, we reported in February 2004 that the Fund's administrative expenses were relatively high when compared with those of three other pension funds. During this audit, we found that the Commissioner is implementing a number of administrative changes designed to improve efficiency and possibly reduce some administrative expenses. However, it is unlikely that administrative expenses will be reduced significantly in the future without legislative action.

Summary of Information Technology Review

As part of obtaining an understanding of internal controls relevant to our audit of the Commissioner's basic financial statements, we performed the following technology-related procedures:

- Updated our risk assessment of the Commissioner's key information systems for accounting and reporting revenues, investments, benefit contributions and payments, and other financial information.
- Validated the Social Security numbers for benefit payment recipients, performed data integrity testing on selected items in the Commissioner's pension system, and performed other procedures deemed necessary.

Detailed Results

Chapter 1

The Fund's Financial Health Continues to Decline, and the Fund Needs \$1,163,758 in Additional Annual Contributions

For the second consecutive biennial valuation, the actuary for the Texas Statewide Emergency Services Personnel Retirement Fund (Fund) has determined that the Fund is not actuarially sound in accordance with the Texas Pension Review Board's definition of actuarial soundness (see text box). Therefore, the Fund also does not

Texas Pension Review Board Definition of "Actuarial Soundness"

A public retirement system is considered actuarially sound if an actuary determines that the fund has sufficient money to pay ongoing normal cost and amortize the unfunded actuarial accrued liability over a period of time not to exceed 40 years, preferably 25 to 30 years.

Texas Civil Statutes Definition of "Actuarially Sound Pension System"

Texas Civil Statutes, Article 6243e.3, Section 1(6), defines "actuarially sound pension system" to be a system in which the amount of contributions is sufficient to cover the normal cost and amortization of the unfunded prior-service cost in a period not to exceed 30 years.

meet its own governing statute's definition of an actuarially sound pension system (Texas Civil Statutes, Article 6243e.3, Section 1(6); see text box). Based on the valuation the Fund's actuary made as of August 31, 2004, the Fund's financial health continues to decline, as its \$13,426,925 projected funding deficit (unfunded actuarial accrued liability) demonstrates.

The Fund's annual benefit payments are expected to exceed its annual fire department governing body contributions, leaving no "surplus" available to amortize the projected funding deficit. When the cost of amortizing the deficit over the statutory 30-year period is considered, the Fund had a contribution deficiency of \$1,163,758 as of August 31, 2004.

In addition, the Fund's actuarial valuation does not include unrecognized net investment losses of \$2.1 million that occurred in prior fiscal years. The Fund will recognize those losses in the next four years, which could increase its projected deficit.

The Fund is not able to amortize its projected funding deficit.

As of August 31, 2004, the Fund's actuary reported that the Fund's projected liabilities exceeded its assets, leaving a projected funding deficit (unfunded actuarial accrued liability) of \$13,426,925. The actuary also reported that the Fund would not be able to amortize this deficit using an expected surplus because the fiscal year 2005 normal costs¹ were expected to exceed contributions by \$15,252. If contributions were to exceed normal costs (as historically has been the case), then the deficit could be amortized, even if it were not within the statutory 30-year period required to be actuarially sound.

As of the end of fiscal year 2004, additional annual contributions of \$1,163,758 were necessary to make the Fund actuarially sound.

The actuary determined that the annual cost of amortizing the projected deficit over the statutory 30-year period was \$1,148,506 as of the end of fiscal year 2004. When this cost is added to the normal costs, the Fund has a contribution deficiency of

¹ Normal costs equal the portion of the present value of pension plan benefits and expenses that are allocated to a given year. The Fund's normal costs are dependent on its actuarial valuation and assumptions.

\$1,163,758. This would appear to require contributions to increase by approximately 57 percent; however, an increase in contributions would also lead to an increase in benefits because pension benefits are directly tied to contributions. One alternative to address this issue would be to reduce benefits significantly, but this could occur only through legislative action.

Table 1 summarizes the Fund's financial position as of August 31, 2004, as compared to its financial position as of August 31, 2002 (the date for which the previous actuarial valuation was conducted).

Table 1

Summary of Actuarial Valuations of the Texas Statewide Emergency Services Personnel Retirement Fund		
	As of August 31, 2002	As of August 31, 2004
Actuarial Accrued Liability	\$45,976,387	\$51,567,426
Actuarial Value of Assets (excludes unrecognized investment gains and losses)	\$32,797,262	\$38,140,501
Unfunded Actuarial Accrued Liability (UAAL)	\$13,179,125	\$13,426,925
Required Contributions in Next Fund Year to Fund Normal Cost	\$1,769,247	\$2,057,794
Expected Contributions in Next Fund Year	\$1,950,169	\$2,042,542
Annual Amount Available to Amortize the UAAL	\$180,922	\$(15,252)
Required Contributions in Next Fund Year to Amortize UAAL over 30 years	\$1,127,310	\$1,148,506
Total Contribution Deficiency	\$946,388	\$1,163,758
Required State Contribution for Next Fund Year (1/3 of Expected Contributions)	\$650,056	\$680,847
Remaining Contribution Deficiency	\$296,332	\$482,911
Years to Amortize the UAAL	Infinity	Infinity

Source: Texas Statewide Emergency Services Personnel Retirement Fund Actuarial Valuation as of August 31, 2004

Fund investment results are improving but are unlikely to correct the projected funding deficit.

The Legislature may need to consider making other adjustments (such as changing eligibility requirements, modifying benefits, or adjusting other funding methods) to restore the Fund's actuarial soundness. To improve actuarial soundness, a pension fund generally has the following options: (1) increase investment returns, (2) increase contributions, and/or (3) adjust benefits. As Table 2 shows, net assets of the Fund decreased from fiscal year 2000 through 2002 and have increased in fiscal years 2003 and 2004, while retirement and survivors' benefits paid have increased every year. Although investment returns have improved significantly, the Fund must still recognize \$2.1 million in prior net investment losses during the next four years in accordance with its actuary's use of a five-year smoothing process to translate annual market returns to actuarial returns. Recognizing the \$2.1 million in deferred net losses could increase the Fund's projected deficit.

Table 2

Summary of the Texas Statewide Emergency Services Personnel Retirement Fund Investment Income, Net Assets, and Benefits Paid					
	Fiscal Year 2000	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004
Expected Investment Rate of Return (Net of Investment Expenses)	8.0%	8.0%	8.0%	8.0%	8.0%
Actual Investment Rate of Return (Net of Investment Expenses)	16.2%	(5.4%)	(10.7%)	11.5%	10.8%
Total Investment Income	\$5,195,315	\$(1,806,854)	\$(3,369,639)	\$3,585,430	\$3,763,555
Investment Expenses	\$(174,631)	\$(142,553)	\$(214,396)	\$(167,343)	\$(225,488)
Net Investment Income	\$5,020,684	\$(1,949,407)	\$(3,584,035)	\$3,418,087	\$3,538,067
Net Assets	\$35,877,482	\$33,795,469	\$29,815,693	\$32,891,831	\$36,029,817
Retirement and Survivors' Benefits Paid	\$1,208,878	\$1,275,921	\$1,380,437	\$1,453,580	\$1,569,846

Sources: Texas Statewide Emergency Services Personnel Retirement Fund Actuarial Valuations as of August 31, 2004, and August 31, 2002; Commissioner's Annual Financial Statements for fiscal years 2000 through 2004

In March 2004, the Fund's actuary estimated that the Fund would need to earn an annual investment return net of investment expenses of 19.37 percent for the next five years and then 8 percent thereafter to be able to amortize the projected funding deficit over the statutory 30-year period and make the Fund actuarially sound. The actuary did not believe that this was a realistic expectation and, therefore, concluded that solely increasing investment return would not restore the Fund's actuarial soundness.

Because the Fund's pension benefits are directly tied to the contributions made, increasing contributions will result in increasing benefits, which may have a negative impact on the Fund's actuarial soundness.

Statutes Require the State to Contribute Up to One-Third of Annual Contributions to the Fund to Maintain Actuarial Soundness

Texas Civil Statutes, Article 6243e.3, Section 2(d), specifies that:

"The state shall contribute the sum necessary to make the [Fund] actuarially sound each year. The state's contribution may not exceed the amount of one-third of the total of all contributions by governing bodies in one year. If the state contributes one-third of the total contributions of the governing bodies in one year, the [Fund] shall be presumed actuarially sound."

Statutes require the State to contribute to the Fund to maintain actuarial soundness.

When the Fund is determined to be actuarially unsound, statutes require the State to contribute up to one-third of the total amount that fire department governing bodies contribute to the Fund (see text box). Given the Fund's projected \$13,426,925 deficit at the end of fiscal year 2004, this means that the State is required to make additional annual contributions of \$680,847 to restore the Fund's actuarial soundness as it is defined in statutes.²

In June 2004, the Commissioner requested \$604,992 and \$612,523 in emergency funding (for fiscal years 2003 and 2004, respectively) from the Office of the

² The \$680,847 amount is one-third of the \$2,042,542 in fire department governing bodies' expected contributions in fiscal year 2005.

Governor. The Commissioner's Legislative Appropriations Request also contains an exceptional item request for \$675,307 and \$709,072 for fiscal years 2006 and 2007, respectively. The Commissioner is researching possible statutory changes that could help strengthen the Fund's financial position.

The Fund would be presumed to be actuarially sound according to Texas Civil Statutes, Article 6243e.3, Section 2(d), if the required additional annual state contributions of \$680,847 were provided; however, the Fund still would not be considered an actuarially sound pension system according to Texas Civil Statutes, Article 6243e.3, Section 1(6). To become considered as such, the Fund would need additional annual contributions of \$482,911 above the annual state contribution to cover normal costs and amortize the projected funding deficit over a 30-year period.

Recommendations

The Commissioner should:

- Continue to research possible changes to the pension plan statutes that may allow the Fund to become and remain actuarially sound.
- Continue to work with the Legislature to obtain the state funding as required by statute.

Management's Response

Recommendation:

"The Commissioner should continue to research possible changes to the pension plan statutes that may allow the Fund to become and remain actuarially sound."

Management's Response:

Both the Commissioner and the Board of Trustees are committed to creating a pension system that will not only respond to the current needs of our fire fighters but also to the future needs of our members and beneficiaries.

As stated in the May 2004 asset liability study, "The fund has a serious actuarial funding problem that must be corrected to protect the future pension benefits of volunteer fire fighters and EMS personnel. Although current benefits are not in danger, there is roughly a 29% chance that the Fund will be exhausted within the next 20 years. The actuarial funding ratio, currently about 70%, is expected to deteriorate to about 46% by 2013 and to 13% by 2023 in the absence of state contributions."

The Board of Trustees and the Commissioner will be working with the leadership of the House and Senate to solve the statutory issues facing the pension fund. The starting point will be to allow the State Board of Trustees the ability to respond to the changing needs of both the fire community and the markets. As the statute is written, there is no ability for the Board of Trustees to address funding issues except through the legislative process every other year. The Board needs to be able to address funding issues as they occur and have the flexibility to address these issues both in good economic times as well as bad.

Recommendation:

“The Commissioner should continue to work with the Legislature to obtain the state funding as required by statute.”

Management’s Response:

Key to making this legislation work will be a method of funding that gives long-term stability to the fund and the agencies’ operations.

Under TSESRA, “the state shall contribute the sum necessary to make the fund actuarially sound each year. The state’s contribution may not exceed the amount of one-third of the total of all contributions by governing bodies in one year”. Pursuant to state statute, the Commissioner and the Board are seeking statutorily mandated state funding for the pension fund during the 79th Legislative Session. Unfortunately, the Fund will remain inadequately financed even with TSESRA mandated state contributions.

The actuarial problems of the Fund are compounded by the administrative funding demands. Since 1998, over \$2,366,371 has been appropriated from the TSESRA pension trust fund to administer agency operations. Prior to this time, the agency was fully funded by General Revenue to support both the statewide volunteer fire fighter pension fund and the Texas Local Fire Fighter’s Retirement Act’s participating municipal fire departments’ pension funds’ programs. In FY 04, the percentage of General Revenue (including appropriations for benefits) to fund agency administrative costs was 21% leaving 79% of the agency’s operating costs being funded by the volunteer fire fighter pension fund.

The agency’s Legislative Appropriations Request for FY 2006 and 2007 seeks full General Revenue funding in accordance with TSESRA and full agency administrative costs to reduce the financial burden on the fund. Emergency appropriations have also been requested through the Governor’s office for FY 2003 and FY 2004. Since this request has not been funded, the Commissioner will ask for these years as well as FY 2005.

In an effort to assist the leadership and address this added demand on General Revenue, the State Board of Trustees and the Commissioner will work with the Legislature to achieve these appropriations through the Fire Insurance Premium Tax. Fire insurance is considered a property and casualty line of business. Property and Casualty premiums are subject to a premium tax based on the aggregate of all lines of business in this category. The premium tax rate for property and casualty premiums is 1.6%. All premium tax is deposited into General Revenue for the state. Currently, Arizona, Georgia, Kansas, Minnesota, Montana, South Carolina and Wyoming contribute between 2% up to 5% of this Fire Insurance Premium Tax to support their volunteer pension systems. By allowing these funds to be dedicated to the volunteer pension fund, it will enable the fund to be stabilized for the long term as well as allow the Board of Trustees and the Commissioner to be confident in recruiting more departments into participating in this fund. It will also allow the state to meet its responsibility under the Texas Statewide Emergency Services Retirement Act (TSESRA).

Status of the Fund's Administrative Costs

In February 2004, we reported that the Fund's ratio of administrative expenses to benefit payments was 45 percent, while the ratios for three other pension funds we reviewed ranged from 1.1 percent to 2.2 percent. We also reported that many of the expenses associated with administering the Fund were fixed and that the Fund's average benefit payment was much lower than that of other pension funds.

During this audit, we found that the Commissioner is implementing a number of administrative changes designed to improve efficiency and possibly reduce some administrative expenses. However, the small size of the agency and the pension plan prevent the agency from realizing efficiencies in administrative expenses from economies of scale. As a result, it is unlikely that administrative expenses paid for from the Fund will be reduced significantly in the future without legislative action.

Other Information

Objective, Scope, and Methodology

Objective

Our objective was to express an opinion on the Fire Fighters' Pension Commissioner's (Commissioner) basic financial statements for the fiscal year ended August 31, 2004.

Scope

The scope of this audit included expressing an opinion on the Commissioner's basic financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits in *Government Auditing Standards* issued by the Comptroller General of the United States.

Methodology

We gained an understanding of the Commissioner's overall internal control structure (control environment, control procedures, and accounting systems) to determine the extent of our audit plan. We tested internal controls and significant accounts as deemed necessary to support our opinion.

Tests of significant account balances and classes of transactions included tests of detailed supporting transactions and confirmations of investments and contributions. In addition, we performed analytical procedures, interviewed Commissioner personnel, and reviewed the annual financial statements. We also tested compliance with applicable laws and regulations relating to investments and benefit payments. We administered questionnaires, reviewed documents, recalculated balances, and compared current-year financial information with that of prior years for reasonableness.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Brian McCall, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Fire Fighters’ Pension Commissioner

Chair and Members of the Texas Statewide Emergency Services Personnel
Retirement Fund Board of Trustees
Ms. Lisa Ivie Miller, Commissioner



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