A Report on

The Teacher Retirement System's Pension and Retiree Health Insurance Plans

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Overall Conclusion

In our audit report dated November 10, 2003, we concluded that the basic financial statements of the Teacher Retirement System (System) for the fiscal year ended August 31, 2003, were materially correct in accordance with accounting principles generally accepted in the United States of America. We compliment the System because, for the sixth consecutive year, we found no instances of significant noncompliance or material weaknesses in internal control.

Background Information

Serving more than 1 million members, the Teacher Retirement System (System):

- Pays benefits to members and beneficiaries.
- Collects member contributions and maintains records of member accounts.
- Collects state contributions.
- Invests the pension trust fund.
- Administers the retirement plan.
- Administers health care plans.
- Provides guidelines for the certification of companies offering investment options under Internal Revenue Code Section 403(b) to school employees.

As of August 31, 2003, the System's pension plan had $77.6 billion in net assets. It paid $4.9 billion in benefits during fiscal year 2003.

As of August 31, 2003, the System's retiree health insurance plan had negative $83.0 million in net assets. It paid $571.7 million in benefits during fiscal year 2003.

Texas Government Code, Section 825.214, requires the System to obtain a financial audit. Our audit opinion is included in the financial section of the System's *Comprehensive Annual Financial Report*, which the System released on November 21, 2003. We also provided the System with a management letter and a report on compliance and internal control.

Other Issues of Legislative Interest

Although current member benefits are not in jeopardy, the System's pension and retiree health insurance plans are both facing important funding challenges comparable to similar benefit programs across the nation. Specific issues of legislative interest include the following:

- In fiscal year 2003, the market value of the pension plan's net assets rose to $77.6 billion. However, based on the valuation the System's actuary made as of August 31, 2003, the pension plan's financial health continued to decline, as the increase in its projected funding shortfall (unfunded actuarial accrued liability) demonstrates. At the end of fiscal year 2003, the pension plan's projected funding shortfall was $5.2 billion, a significant increase from the $3.3 billion projected funding shortfall it faced at the end of fiscal year 2002. Although additional annual funding is not needed immediately to cover current member benefits, additional funding would be necessary over the long term to amortize the pension plan's unfunded liability. Assuming that pension benefits remain the same and investment returns do not improve significantly, additional funding (above the current contribution rates) of $329 million per year would be needed to amortize the unfunded liability over a 30-year period.

- The System's actuary has advised the System that "caution is warranted" regarding the pension plan and that the System's Board of Trustees "should begin preparing the Legislature for a recommended increase in the contribution rate for the next biennium." The actuary further advised that "for the foreseeable future, no benefit enhancements, including ad hoc increases, should be considered without significant contribution rate increases." If contributions are not increased and investment returns do not improve significantly, the Legislature would need to consider making other adjustments (such as changing the retirement eligibility requirements or adjusting other funding methods) to maintain the pension plan's actuarial soundness. The System plans to continue working closely with the Legislature and the Governor to ensure the viability of both the pension plan and the retiree health insurance plan.

The pension plan's investment returns, membership growth, benefit enhancements, and contribution changes have had a direct impact on its actuarial position. Pension plan benefits have increased significantly since 1991, contribution rates were reduced to 6 percent in 1995, and the pension plan experienced significant investment gains in the 1990s and significant investment losses early in the 2000s.

- Consistent with the System's actuary's smoothing process, the pension plan's actuarial valuation does not include $11.4 billion in net investment losses that occurred in prior fiscal years. Although the pension plan realized investment gains during fiscal year 2003, those gains were not large enough to offset prior losses. The pension plan must still recognize its prior investment losses during the next three years in accordance with the System's actuary's use of a smoothing process to translate annual market returns to actuarial returns. To offset these losses, the System's actuary estimates that the pension plan would need to earn an average 12.7 percent return on investments during the next three years. The System's actuary has specified that it is unlikely the pension plan will be able to offset these losses and, even if it does, the $5.2 billion unfunded liability would still necessitate an increase in the contribution rate.

- Even with the addition of $124.7 million in supplemental state appropriations, the net assets of the System's retiree health insurance plan were negative $83.0 million at the end of fiscal year 2003. Unlike the pension plan, which has sufficient funding to pay current member benefits, the retiree health insurance plan has faced increasing enrollment and rising health care costs that have presented this plan with funding challenges.

  The 78th Legislature and the System's Board of Trustees made changes that will help the retiree health insurance plan remain solvent and be able to pay claims during the 2004–2005 biennium, but increases in both enrollment and health care costs may require further changes in the future to ensure that the plan stays solvent. To maintain the solvency of the retiree health insurance plan for the 2004–2005 biennium, the Legislature increased state and employee contributions and began requiring school districts to make contributions; the System's Board of Trustees also increased premiums and co-payments.

- In its Legislative Appropriations Request for the 2004–2005 biennium, the System requested $1.369 billion to keep the retiree health insurance plan solvent through August 31, 2005. The Legislature appropriated $758.6 million. The System projects that the difference between the amount the System requested and the amount it was appropriated will be covered by the increases in contributions, premiums, and co-payments.

- Recent changes to Medicare prescription drug benefits made at the federal level also could have a significant impact on the retiree health insurance program. The specific impact those changes could have is unknown at this time.

On September 1, 2002, the System launched TRS-ActiveCare, a statewide health care program for active school district employees and their dependents established by House Bill 3343 (77th Legislature). A self-funded health insurance plan, TRS-ActiveCare had net assets of $136.4 million at the end of fiscal year 2003. It achieved an operating income of $67.1 million during fiscal year 2003. As of September 1, 2003, a total of 992 of the 1,245 school districts in Texas participated in TRS-ActiveCare, and 129,973 employees and their 82,383 dependents were enrolled in the program.

Summary of Information Technology Review

Overall, the System's information systems appeared to be working properly and enabled the System to report financial results accurately. Results of our tests of reconciliations and the financial transactions that the System's information systems processed indicated that the System reported accurate amounts in its financial statements. In addition, access to the System's General Ledger Accounting System (GLAS) was limited to authorized personnel, although we noted that the System's accounting manuals need to be updated. Overall, the risk that information technology problems could lead to errors in the financial statements was minimal.

In the previous year, we reported that the System had started taking corrective action on weaknesses in the documentation of information security roles, policies, and standards by developing an information security manual. The System has now completed this manual.

As part of obtaining an understanding of internal controls relevant to the audit of the fiscal year 2003 basic financial statements, we performed the following information technology–related procedures:

- Reviewed computer center physical security controls
- Reviewed the System's on-line retirement benefit calculator program for processing integrity
- Reviewed the accounting system's edit controls and processing integrity, which included a reconciliation of financial statement balances to total fiscal year data from the accounting system
- Compared the list of current authorized users of GLAS with the list of terminated employees during fiscal year 2003 to determine whether the System had properly deactivated access for terminated employees
- Examined and relied on reviews of information systems conducted by other parties, such as the Department of Information Resources and the System's Internal Audit Department
- Identified key information systems the System used in financial reporting