A Report on

The Fire Fighters' Pension Commissioner's Texas Statewide Emergency Services Personnel Retirement Fund for Fiscal Year 2003

February 2004

Report No. 04-021

State Auditor's Office

Lawrence F. Alwin, CPA
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Overall Conclusion

In our audit report dated January 7, 2004, we issued an unqualified opinion regarding whether the basic financial statements of the Fire Fighters' Pension Commissioner (Commissioner) for the fiscal year ended August 31, 2003, were materially correct in accordance with accounting principles generally accepted in the United States of America.

Background Information

- Created in 1937, the Fire Fighters' Pension Commissioner (Commissioner) provides retirement, death, and disability benefits to firefighters. At the end of fiscal year 2003, the Commissioner's Texas Statewide Emergency Services Personnel Retirement Fund (Fund) had 7,931 members.
- The amount of retirement benefits the Fund paid to eligible participants in fiscal year 2003 ranged from $8 to $593 per month.
- Statute requires 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.
- Statute defines an actuarially sound pension system as 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.

Other Issues of Legislative Interest

Although we noted no problems with the Commissioner's basic financial statements, as of fiscal year 2002, the Commissioner's Texas Statewide Emergency Services Personnel Retirement Fund (Fund) was actuarially unsound. Current member benefits are not in jeopardy; however, based on the valuation the Commissioner's actuary made as of August 31, 2002, the Fund's financial health is declining, requiring $946,388 in additional annual contributions beginning in fiscal year 2003. In addition, the Fund's administrative costs in relation to its benefit payments remain excessively high. Specifically:

- The Fund had a $13,179,125 projected funding shortfall (unfunded actuarial accrued liability) as of fiscal year 2002, and the Commissioner's actuary determined that the Fund was not actuarially sound. Until the Commissioner receives the actuary's next valuation report, it will not know the current status of the Fund's financial health.

- Even with benefits remaining the same, statute required the State to make additional annual contributions of $650,056 beginning in fiscal year 2003 to restore the Fund's actuarial soundness as it is defined in statute. On top of that amount, beginning in fiscal year 2003, additional annual contributions from other sources of $296,332 were needed. If contributions are not increased or investment returns do not improve significantly, the Legislature would need to consider making other adjustments (such as changing eligibility requirements, modifying benefits, increasing fire department participation, or adjusting other funding methods) to restore the Fund's actuarial soundness.

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This audit was conducted in accordance with Texas Government Code, Section 321.0131.

For more information regarding this report, please contact Carol Smith, Audit Manager, at (512) 936-9500.

- Consistent with the Commissioner's actuary's smoothing process, the Fund's actuarial valuation did not include $6.1 million in net investment losses that occurred in prior fiscal years. The Fund must still recognize its prior investment losses during the next three years. Recognizing the $6.1 million in deferred losses could increase the Fund's projected shortfall.

- During fiscal year 2003, 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. The expenses associated with administering the Fund are relatively high, but many of these expenses are fixed. In addition, due to the pension plan's design, the Fund's average benefit payment of $84 per month is much lower than that of other pension funds. Significant changes are necessary to improve this ratio. These changes could include modifying the pension plan's design, increasing fire department participation, and/or reducing administrative expenses. Even with those types of changes, more wide-ranging options (such as assigning the administration of the Fund to another agency) would likely be necessary to improve this ratio.

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

- Recalculated and compared the amount of benefit payments for selected eligible participants and performed other procedures deemed necessary

Detailed Results

Chapter 1

The Fund's Financial Health Is Declining and, Based on an Actuarial Valuation Made as of the End of Fiscal Year 2002, It Needed $946,388 in Additional Annual Contributions

We issued an unqualified opinion on the Fire Fighters' Pension Commissioner's (Commissioner) basic financial statements for the fiscal year ended August 31, 2003, and found that those statements were materially correct in accordance with accounting principles generally accepted in the United States of America. Conducting our audit of the Commissioner's financial statements also enabled us to obtain additional information on other issues of legislative interest.

The Commission's actuary has determined that the Fund is not actuarially sound. Current member benefits are not in jeopardy. However, based on the valuation the Commissioner's actuary made as of August 31, 2002, the Texas Statewide Emergency Services Personnel Retirement Fund's (Fund) financial health is declining, as its $13,179,125 projected funding shortfall (unfunded actuarial accrued liability) demonstrates. In addition, the Fund's actuarial valuation does not include unrecognized net investment losses of $6.1 million that occurred in prior fiscal years. Recognizing the $6.1 million in deferred losses could increase the Fund's projected shortfall.

Statute Requires 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."

Statute Defines an "Actuarially Sound" Pension System as a System for Which the Projected Funding Shortfall Can Be Amortized Over a 30-Year Period

Texas Civil Statutes, Article 6243e.3, Section 1(6), specifies that:

" 'Actuarially sound pension system' means 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."

As of the end of fiscal year 2002, $946,388 in additional annual contributions were necessary to make the Fund actuarially sound, cover normal costs, and amortize the projected funding shortfall over a 30-year period.

To make the Fund actuarially sound each year, statute requires the State to contribute up to one-third of the total amount that fire department governing bodies contributed to the Fund. Given the Fund's projected shortfall at the end of fiscal year 2002, this meant that, beginning in fiscal year 2003, the State was required to make additional annual contributions of $650,056 to restore the Fund's actuarial soundness as it is defined in statute.[1]

Statute also defines an actuarially sound pension fund as a fund for which contributions are sufficient to amortize the projected funding shortfall over a 30-year period. Because the required additional annual state contribution of $650,056 would not be

[1] The $650,056 amount is one-third of the $1,950,169 in fire department governing bodies' expected contributions in fiscal year 2003.

enough to cover normal costs[2] and amortize the projected funding shortfall over a 30-year period, additional annual contributions of $296,332 were needed beginning in fiscal year 2003. If contributions are not increased or investment returns do not improve significantly, the Legislature would need to consider making other adjustments (such as changing eligibility requirements, modifying benefits, increasing fire department participation, or adjusting other funding methods) to restore the Fund's actuarial soundness.

The exact amounts of these additional annual contributions were not known at the end of fiscal year 2002 because the Texas Statewide Emergency Services Personnel Retirement Fund Board of Trustees (Board) did not approve the actuarial report that an actuary issued for the Fund for fiscal year 2002 (that report contained incorrect actuarial calculations and estimates).[3]

The Board subsequently hired a different actuary and, in October 2003, that actuary provided an actuarial valuation as of the end of fiscal year 2002. In that report, the actuary specified that the Fund "is not adequately financed on an actuarially sound basis" and recommended that the Board study "possible ways to restore an adequate financial arrangement." The actuary also stressed that it is important for the Board to begin communicating with the Legislature regarding the inadequate financing arrangement. Historically, the Commissioner has obtained actuarial valuations only on a biennial basis; therefore, the Fund's projected shortfall as of the end of fiscal year 2003 will not be known until the next actuarial valuation.

Consistent with the Commissioner's actuary's smoothing process, the Fund's actuarial valuation did not include $6.1 million in net investment losses that occurred in prior fiscal years.

The Fund must still recognize $6.1 million in prior investment losses during the next three years in accordance with its actuary's use of a smoothing process to translate annual market returns to actuarial returns. Recognizing the $6.1 million in deferred losses could increase the Fund's projected shortfall.

As Table 1 shows, net assets of the Fund decreased from fiscal year 2000 through 2003, and net investment income fluctuated from year to year. If investment returns do not improve significantly over the long term and if contributions, benefits, eligibility requirements, and fire department participation rates remain the same, the Fund may not be able to meet future benefit payments or accrued liabilities.

[2] Normal costs equal the amount needed to pay benefits for one year. The Fund's normal costs are dependent on its actuarial valuation and assumptions.

[3] In March 2003, the State Auditor's Office estimated that the required additional annual state contribution could be as high as $605,956 but cautioned that this amount may still not be enough to make the Fund actuarially sound (see *An Audit of the Basic Financial Statements of the Office of the Fire Fighters' Pension Commissioner for the Fiscal Year Ended August 31, 2002*, SAO Report No. 03-027).

Table 1

Summary of Decreases in the Texas Statewide Emergency Services Personnel Retirement Fund Investment Income and Net Assets				
	Fiscal Year 2000	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2003
Expected Investment Rate of Return (Net of Investment Expenses)	8.0%	8.0%	8.0%	8.0%
Actual Investment Rate of Return (Net of Investment Expenses)	13.74%	(5.22%)	(10.70%)	12.50%
Total Investment Income	$5,195,315	$(1,806,854)	$(3,369,639)	$3,585,430
Investment Expenses	$(174,631)	$(142,553)	$(214,396)	$(167,343)
Net Investment Income	$5,020,684	$(1,949,407)	$(3,584,035)	$3,418,087
Net Assets	$35,877,482	$33,795,469	$29,815,693	$32,891,831

Source: Commissioner Annual Financial Statements for fiscal years 2000 through 2003

Recommendation

The Commissioner should implement its actuary's recommendations, and it should ensure that the Board studies ways to restore an adequate financial arrangement and communicates with the Legislature regarding the Fund's inadequate financing arrangement.

Management's Response

The Commissioner and the Board are developing a long-term solution to address the funding and plan design problems facing the system. It is important to remember that the Board did not have a valid actuarial valuation to properly gauge the actuarial soundness of the plan until November 7, 2003. The Commissioner and Board are now able to develop an actuarially sound financing arrangement that will protect and enhance the vested benefits of firefighters and EMS personnel in the system.

Before any recommendation can be made to the Legislature, the Commissioner and the Board will need to complete a thorough analysis of plan liabilities and asset allocation. The Commission is working closely with the actuary to improve the quality of the membership data that is used to determine actuarial liabilities. Enhancements made to the pension database structure during the past year will also improve the accuracy of the data used by the actuary to measure plan liabilities.

The Board has also directed its investment consultant to conduct an asset liability study to determine the optimum asset allocation needed to fund the long-term liabilities of the pension system. The Board will receive the results of this asset-liability study at the May 2004 meeting and will consider rebalancing the portfolio if needed.

The Commissioner and the Board of Trustees have enacted a comprehensive program to notify the leadership, the legislature, and participating departments *about the pension plan's inadequate funding arrangement. On November 24, the Board Chairman and the Commissioner sent a letter to each participating department about the funding problem. On November 24, 2003, the Board Chairman and the Commissioner sent a letter to the leadership and to each member of the legislature advising them that the pension fund is actuarially unsound. This letter was followed by a briefing at the State Capitol on December 4, 2003, to advise legislative staffers in greater detail about the pension system and the funding problem.*

Chapter 2

The Expenses Associated with Administering the Fund Are Higher than Those for Other Pension Funds

As Table 2 shows, during fiscal year 2003, the Fund's ratio of administrative expenses to benefit payments was 45 percent, while the ratios of administrative expenses to benefit payments for three other pension funds we reviewed ranged from 1.1 percent to 2.2 percent.

The expenses associated with administering the Fund are relatively high, but many of these expenses are fixed. In addition, due to the pension plan's design, the Fund's average benefit payment of $84 per month is much lower than that of other pension funds. Significant changes are necessary to improve the ratio of administrative expenses to benefit payments. These changes could include modifying the pension plan's design, increasing fire department participation, and/or reducing administrative expenses. Even with those types of changes, more wide-ranging options (such as assigning the administration of the Fund to another agency) would likely be necessary to improve this ratio.

Table 2

Comparison of Texas Statewide Emergency Services Personnel Retirement Fund Administrative Expenses with Administrative Expenses of Other Pension Funds

Fund	Fiscal Year Ended	Total Benefit Payments	Total Administrative Expenses	Ratio of Administrative Expenses to Benefits
Texas Statewide Emergency Services Personnel Retirement Fund	August 31, 2003	$1,504,767	$670,492	44.6%
City of Austin	December 31, 2002	$75,246,711	$1,641,675	2.2%
Texas Municipal Retirement System	December 31, 2002	$441,943,317	$8,389,416	1.9%
Texas Employees Retirement System	August 31, 2003	$1,086,002,704	$12,364,102	1.1%

Sources: Pension funds listed above

In addition, as Table 3 shows, the Fund's ratio of administrative expenses to benefit payments ranged from a low of 42 percent to a high of 48 percent between fiscal year 2000 and fiscal year 2003. This is a result of the Fund's relatively small membership and the fact that its average monthly benefit payment was relatively low compared with that of other pension plans.

Table 3

Summary of Texas Statewide Emergency Services Personnel Retirement Fund Financial and Membership Information				
	Fiscal Year 2000	**Fiscal Year 2001**	**Fiscal Year 2002**	**Fiscal Year 2003**
Member Contributions	$1,685,318	$1,891,628	$1,817,869	$1,833,310
Fund Deductions:				
Annuity Payments	$ 1,243,928	$1,316,717	$1,421,053	$1,494,382
Death Benefit Payments	101,484	77,009	68,668	10,385
Administrative Expenses	571,249	630,508	712,763	670,492
Total Fund Deductions	$1,916,661	$2,024,234	$2,202,484	$2,175,259
Member Contributions minus Total Fund Deductions	$(231,343)	$(132,606)	$(384,615)	$(341,949)
Net Investment Income	$5,020,684	$(1,949,407)	$(3,584,035)	$3,418,087
Net Increase (Decrease) in Net Assets	$4,789,341	$(2,082,013)	$(3,968,650)	$3,076,138
Plan Members	7,114	7,464	7,683	7,931
Members Receiving Benefits	1,250	1,330	1,403	1,468
Average Monthly Benefit	$83	$83	$84	$84
Ratio of Administrative Expenses to Benefit Payments	42%	45%	48%	45%

Source: Commissioner Annual Financial Statements for fiscal years 2000 through 2003

In 2002, we reported that the Fund's administrative expenses were increasing and recommended that the Board continue to evaluate whether these expenses were reasonable and necessary for the prudent management of the Fund (see *An Audit Report on the Fiscal Year 2001 Financial Statements of the Office of the Fire Fighters' Pension Commissioner*, SAO Report No. 02-053, June 2002). The Board reduced administrative expenses for the Fund between 2002 and 2003 by $42,271. However, because certain administrative expenses are fixed and will remain relatively high, it could be beneficial for the Legislature to consider other alternatives for administering the Fund while maintaining current levels of service to fire departments. One alternative for consideration could be to transfer the administration of the Fund to another state agency that administers pension funds. Under that alternative, investment costs would be paid at lower rates, and a significant portion of the fixed administrative expenses could be absorbed without incurring additional incremental costs.

Recommendation

The Commissioner and the Board should explore options for reducing expenses associated with administering the Fund.

Management's Response

The Commissioner and the Board will continue to explore options for reducing administrative expenses that will not reduce service to the departments or internal financial controls. The Board of Trustees is currently conducting a cost-benefit analysis to consider contracting the plan administration to another agency or a private contractor. This analysis will need to consider the plan complexity, current operating costs, and the value of indirect services currently provided by the State at no charge.

This cost-benefit analysis will also need to consider the factors that have resulted in higher administrative costs for the system.

1. *General revenue is no longer appropriated for the administration of the fund.*
2. *The pension fund is subsidizing the operation of the pension commission office.*
3. *The TSESRA system is the most complex public pension system in the State and it is inherently difficult to administer.*
4. *The system has grown to over 7,900 members, over 2,000 payees, representing 175 participating departments.*
5. *The Commissioner has followed recommendations from the State Auditor to hire the additional staff needed to implement internal controls.*
6. *The TSESRA act mandates that the Commissioner administer the local pension system of a merging department at no charge despite the increased administrative costs.*

The cost-benefit analysis will also need to identify an appropriate benchmark for the comparison of the system's administrative costs. The SAO measured the efficiency of the system against multi-billion dollar pension funds that benefit from economies of scale and simpler plan design. Another problem with the SAO's methodology is that it compares the TSESRA system with its fixed dollar contribution rate to pension systems with benefits tied to and funded by payroll contributions.

Payroll based contributions reflect salary and inflationary increases over time, whereas the fixed dollar method funding the TSESRA system has not kept pace with inflation. Since 1977, the TSESRA system is based upon a $12.00 per member monthly minimum contribution. This minimum contribution rate would be $36.15 had it been tied to the consumer price index.

As a result, the retirement benefits paid to retired volunteer firefighters and EMS personnel have not kept pace with inflation. Under the current benefit formula (member's average contribution rate multiplied by 6 for 15 Years of Service) the minimum monthly pension paid by the system would be approximately $216.00 instead of $72.00. As a result the total assets of the fund are probably one-third of their inflation-adjusted value and the ratio of administrative expenses would be reduced proportionally.

Auditor's Follow-Up Comment

To demonstrate our position, we intentionally compared the Fund's administrative expenses with the administrative expenses of other types of pension funds that can benefit from economies of scale. Such a comparison supports our suggestion that transferring the administration of the Fund to another state agency that is already administering pension funds (and, therefore, can benefit from economies of scale) could reduce administrative expenses.

We agree that, under statute, contributions to the Fund have never been linked with the rate of inflation. Because contributions do not keep pace with inflation, it is likely that the Fund's ratio of administrative expenses to benefits will remain relatively high. This further supports our suggestion that transferring the administration of the Fund to another state agency could reduce administrative expenses.

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, 2003.

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, maximum cash balance at the State Treasury, and benefit payments. We administered questionnaires, reviewed documents, recalculated balances, and compared current-year financial information with that of prior years for reasonableness.

Distribution Information

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