December 11, 2006

Members of the Legislative Audit Committee:

In our audit report dated November 7, 2006, we concluded that the Teacher Retirement System’s (System) basic financial statements for fiscal year 2006 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards. Our procedures did not identify any material weaknesses in internal control over financial reporting or any noncompliance with laws or regulations that materially affected the financial statements. However, our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations.

The major internal controls that we tested for the purpose of forming our opinion on the financial statements were operating effectively. As required by professional auditing standards, we will also communicate certain matters related to the conduct of a financial statement audit to the Audit Committee of the System’s Board of Trustees.

Conducting our audit of the System’s financial statements enabled us to obtain information on the pension plan’s actuarial funding status. The plan’s funded ratio (the ratio of actuarial assets to actuarial liabilities) improved slightly to 87.3 percent at the end of fiscal year 2006 (this ratio was 87.1 percent at the end of fiscal year 2005). However, the plan’s unfunded actuarial accrued liability (UAAL), which represents the deficit of the plan’s actuarial assets compared with its actuarial liabilities, grew by $0.5 billion to $13.7 billion.

In spite of the large actuarial funding deficit, the pension plan’s overall funding position improved during fiscal year 2006. The plan’s investments earned 9.7 percent during fiscal year 2006, which is higher than the 8 percent assumed long-term rate of return used for actuarial valuation purposes. The average annual return on the plan’s investments for the past 10 years has been 9.2 percent. The investment losses the plan suffered during the capital market downturn in fiscal years 2001 and 2002 are fully reflected in the current actuarial valuation, and now the plan is deferring $6 billion of investment gains to future years. According to the plan’s actuary, in the absence of actuarial losses in the future, the plan’s funded status should improve.
as these deferred gains are recognized over the next four years. Table 1 summarizes investment results for the past seven years and other actuarial information regarding the pension plan.

Table 1

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Rate of Return for Investments</th>
<th>Unfunded Actuarial Accrued Liability (UAAL)</th>
<th>Funded Ratio</th>
<th>Annual Required Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>9.7 %</td>
<td>$13.7 billion</td>
<td>87.3 %</td>
<td>7.19 %</td>
</tr>
<tr>
<td>2005</td>
<td>14.4 %</td>
<td>$13.2 billion</td>
<td>87.1 %</td>
<td>7.31 %</td>
</tr>
<tr>
<td>2004</td>
<td>11.9 %</td>
<td>$8.0 billion</td>
<td>91.8 %</td>
<td>7.39 %</td>
</tr>
<tr>
<td>2003</td>
<td>11.3 %</td>
<td>$5.2 billion</td>
<td>94.5 %</td>
<td>7.15 %</td>
</tr>
<tr>
<td>2002</td>
<td>-7.8 %</td>
<td>$3.3 billion</td>
<td>96.3 %</td>
<td>5.70 %</td>
</tr>
<tr>
<td>2001</td>
<td>-10.6 %</td>
<td>-$2.1 billion</td>
<td>102.5 %</td>
<td>4.12 %</td>
</tr>
<tr>
<td>2000</td>
<td>14.0 %</td>
<td>-$5.4 billion</td>
<td>107.4 %</td>
<td>4.92 %</td>
</tr>
</tbody>
</table>

Source: Teacher Retirement System.

At the end of fiscal year 2006, the plan’s net assets exceeded $100 billion for the first time in history. In addition, the rate of annual required contribution of the State for fiscal year 2007 (the contribution rate that is needed to eliminate the actuarial funding deficit within the next 30 years) has decreased to 7.02 percent of pay from the previous year’s 7.19 percent.

Although the outlook for the pension plan has improved significantly over the last two actuarial valuations, the System’s actuary continues to advise caution over the next few years. The actuary recommends that the Legislature not provide a benefit increase over the next several legislative sessions without adequate funding, and that the funded status should be carefully monitored. According to the actuary’s calculation, the current total annual contribution rate of 12.4 percent of pay (6.0 percent from the State and 6.4 percent from active members) is not sufficient to pay off, or amortize, the current UAAL. Therefore, the plan’s amortization period remains “infinite,” as it has been since the fiscal year 2002 valuation.

The System’s actuary calculated that raising the State’s contribution rate to 7.02 percent of pay starting in fiscal year 2007 would position the plan to amortize the unfunded liability over the next 30 years. A 30-year amortization period is important because state law prohibits making certain changes to the plan, such as increasing benefits, if (1) the amortization period is 31 or more years or (2) the changes would increase the amortization period to 31 or more years (see Texas Government Code, Section 821.006).

We estimate that the higher contribution rate calculated by the actuary (7.02 percent) would require the State to increase its General Revenue contribution to the pension plan for the 2008-2009 biennium by approximately $813.1 million. Of that amount, $521.6 million is directly due to the increased contribution rate. The other $291.5 million is the contribution the State is expected to make as a result of projected increases in payroll over the biennium. Our estimate assumes that the annual active member payroll and state contribution amounts will grow at 7 percent during fiscal year 2007 and 5 percent during fiscal years 2008 and 2009. The System projected these growth rates in its Legislative Appropriations Request dated August 11, 2006.
The Governmental Accounting Standards Board has issued Statements No. 43 (Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans) and No. 45 (Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions). Statement No. 43 will require the System to disclose information about the current funded status of TRS-Care, the health insurance plan for retirees, effective fiscal year 2007. Statement No. 45 will require the State of Texas to report the cost of future health benefits in its financial statements effective fiscal year 2008. To implement the requirements of Statement No. 43, the System plans to conduct an actuarial valuation for TRS-Care during fiscal year 2007. This valuation will provide information about the unfunded actuarial accrued liability of the plan, as well as the annual required contribution necessary to fund future retiree health benefits.

We appreciate the System’s cooperation during this audit. If you have any questions, please contact Verma Elliott, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

cc: Members of the Teacher Retirement System Board of Trustees
    Mr. Ronnie G. Jung, Executive Director, Teacher Retirement System
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