December 10, 2007

Members of the Legislative Audit Committee:

In our audit report dated November 6, 2007, we concluded that the Teacher Retirement System’s (System) basic financial statements for fiscal year 2007 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. However, we reported some less significant issues in accounting and financial reporting controls, information technology controls, and certain actuarial consulting contract specifications to System management in a separate letter dated December 7, 2007.

As required by professional auditing standards, we will also communicate to the Audit Committee of the System’s Board of Trustees certain matters related to the conduct of a financial statement audit.

Conducting our audit of the System’s financial statements enabled us to obtain information on the actuarial funding status of the pension plan and retiree health care plan. That information is summarized below.

Pension Plan Financial Highlights and Actuarial Funding Status

The pension plan’s funded ratio (the ratio of actuarial assets to actuarial liabilities) improved for the second consecutive year to 89.2 percent at the end of fiscal year 2007 (this ratio was 87.3 percent at the end of fiscal year 2006). Additionally, the plan’s unfunded actuarial accrued liability (UAAL), which represents the deficit of the plan’s actuarial assets compared with its actuarial liabilities, decreased by $1.2 billion to $12.5 billion.

Background Information

The Teacher Retirement System (System), under Article 16, Section 67, of the Texas Constitution, is authorized to provide retirement and related benefits for employees of public schools, colleges, and universities supported by the State of Texas. The System also administers health care plans for retirees (TRS-Care), active public school employees (TRS-ActiveCare), and their dependents.

The System is responsible for investing funds under its stewardship and for delivering benefits to members as authorized by the Legislature. The System’s pension plan is a defined benefit plan, with retirement benefits determined by a pre-established formula.

As of August 31, 2007, the System was serving 1,201,038 members—935,731 were public and higher education employees and 265,307 were annuitants. These members were employed by 1,347 entities, including school districts, charter schools, colleges, and universities. The pension plan’s net assets totaled approximately $112.1 billion as of August 31, 2007. The System paid $5.8 billion in benefit payments during fiscal year 2007.
In spite of the large actuarial funding deficit, the pension plan’s overall funding position improved during fiscal year 2007. The plan’s investments earned 14.4 percent during fiscal year 2007, 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 8.2 percent. The plan is deferring $8.7 billion of investment gains to be recognized in future valuations. 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 and other actuarial and contribution rate information regarding the pension plan for fiscal years 1998 through 2008.

Table 1

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Rate of Return on Investments</th>
<th>Unfunded Actuarial Accrued Liability (UAAL)</th>
<th>Funded Ratio</th>
<th>Annual Required Contribution (ARC) (Actuarially Determined)</th>
<th>Actual Contribution Rate (Statutorily Determined)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>(Data will not be available until after August 31, 2008)</td>
<td></td>
<td></td>
<td>6.47%</td>
<td>6.58%</td>
</tr>
<tr>
<td>2007</td>
<td>14.4%</td>
<td>$12.5 billion</td>
<td>89.2%</td>
<td>7.02%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2006</td>
<td>9.7%</td>
<td>$13.7 billion</td>
<td>87.3%</td>
<td>7.19%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2005</td>
<td>14.4%</td>
<td>$13.2 billion</td>
<td>87.1%</td>
<td>7.31%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2004</td>
<td>11.9%</td>
<td>$8.0 billion</td>
<td>91.8%</td>
<td>7.39%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2003</td>
<td>11.3%</td>
<td>$5.2 billion</td>
<td>94.5%</td>
<td>7.15%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2002</td>
<td>-7.8%</td>
<td>$3.3 billion</td>
<td>96.3%</td>
<td>5.70%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2001</td>
<td>-10.6%</td>
<td>-$2.1 billion</td>
<td>102.5%</td>
<td>4.12%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2000</td>
<td>14.0%</td>
<td>-$5.4 billion</td>
<td>107.4%</td>
<td>4.92%</td>
<td>6.00%</td>
</tr>
<tr>
<td>1999</td>
<td>21.0%</td>
<td>-$2.2 billion</td>
<td>103.3%</td>
<td>4.12%</td>
<td>6.00%</td>
</tr>
<tr>
<td>1998</td>
<td>8.1%</td>
<td>-$2.5 billion</td>
<td>104.3%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
</tbody>
</table>

Source: Teacher Retirement System.

At the end of the fiscal year 2007, the plan’s net assets exceeded $112 billion. In addition, the rate of annual required contribution (ARC) of the State for fiscal year 2007 (the contribution rate that is needed to eliminate the actuarial funding deficit within the next 30 years) decreased to 7.02 percent of pay from the previous year’s 7.19 percent.

The Legislature increased the State’s contribution rate to 6.58 percent starting in fiscal year 2008. As a result, fiscal year 2008 is projected to be the first year since fiscal year 2002 in which the State’s contributions to the pension plan equal or exceed the amount needed to amortize the UAAL over 30 years. A 30-year amortization period is important because state law prohibits making certain changes to the pension 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).
On November 9, 2007, the System’s Board of Trustees voted to authorize payment of a supplemental monthly retirement payment (that is, a “13th check”) to System retirees in January 2008. The actuary stated that the System would not have met legal requirements to authorize this payment if the State contribution had not been increased from 6.00 percent to 6.58 percent.

According to the actuary’s calculation, the current total annual contribution rate of 12.98 percent of pay (6.58 percent from the State and 6.4 percent from active members) is sufficient to amortize the current UAAL over 27.4 years. (The amortization period would have been 25.9 years if the Board had not authorized the 13th check.) Fiscal year 2007 is the first year since fiscal year 2002 that there has been a measurable, rather than an infinite, amortization period.

Although the outlook for the pension plan improved, the System’s actuary continued to advise caution for the next few years. The actuary recommended that the Legislature not provide a benefit increase during the next several legislative sessions without adequate funding.

Retiree Health Care Plan Actuarial Funding Status

The System has implemented Statement No. 43 of the Governmental Accounting Standards Board - Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans (GASB 43). In accordance with GASB 43, the initial actuarial valuation of the retiree health plan disclosed the following as of August 31, 2007:

- The unfunded actuarial accrued liability was $19.1 billion ($19.7 billion of actuarial accrued liability less $623 million of plan assets). Therefore, the plan’s funded ratio (actuarial assets/actuarial liabilities) was 3 percent.

- The actuarially determined annual required contribution (ARC, or the annual contribution rate that would be sufficient to eliminate the unfunded actuarial accrued liability within the next 30 years) from employers and other contributing entities for fiscal year 2007 was 6.03 percent of payroll ($1.4 billion). However, the retiree health care plan historically has been funded on a “pay as you go” basis (contribution rates are intended to be sufficient to meet the current year’s health care costs), rather than being funded on an actuarially determined basis. During fiscal year 2007, the State contributed 1.0 percent ($238 million), school districts contributed 0.55 percent ($136 million), and Medicare Part D reimbursements totaling $52 million were received from the federal government. These contributions totaled only $426 million (30 percent) of the $1.4 billion ARC for fiscal year 2007. Therefore, this left approximately $1 billion of the ARC unfunded in fiscal year 2007.

- The actuarial assumed rate of return on plan investments, which include only short-term investments, was 5.25 percent. Using that rate, the actuary projected that $1.573 billion will
be needed to fully fund the ARC during fiscal year 2008. However, if contribution rates were increased so that the plan could accumulate enough assets to invest using a long-term strategy and use the same 8.00 percent assumed rate of return that is used for the pension plan, the State and school districts instead would be required to contribute $1.106 billion to fully fund the ARC in fiscal year 2008. This amount is $467 million less than the amount that would be needed using the 5.25 percent assumption (all amounts exclude contributions from active employees).

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, CPA, Executive Director, Teacher Retirement System
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