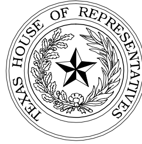
HOUSE COMMITTEE ON PENSIONS & INVESTMENTS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2004

A REPORT TO THE
HOUSE OF REPRESENTATIVES
79TH TEXAS LEGISLATURE

REP. ALLAN RITTER
CHAIRMAN

COMMITTEE CLERK
SHERRI WALKER



Committee On
Pensions & Investments

November 24, 2004

Rep. Allan Ritter
Chairman

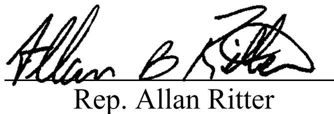
P.O. Box 2910
Austin, Texas 78768-2910

The Honorable Tom Craddick
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

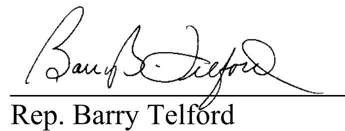
Dear Mr. Speaker and Fellow Members:

The Committee on Pensions & Investments of the Seventy-Eighth Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Seventy-ninth Legislature.

Respectfully submitted,



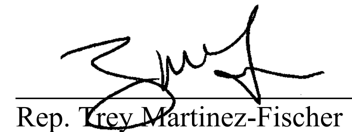
Rep. Allan Ritter



Rep. Barry Telford

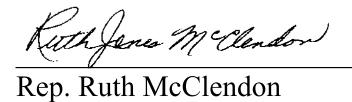
Rep. Kent Grusendorf

Rep. Patrick Rose



Rep. Trey Martinez-Fischer

Rep. Aaron Pena



Rep. Ruth McClendon

Rep. Kent Grusendorf
Vice-Chairman

Members: Rep. Barry Telford, Rep Patrick Rose, Rep. Trey Martinez-Fischer, Rep. Aaron Pena, Rep. Ruth McClendon

TABLE OF CONTENTS

INTRODUCTION 4
INTERIM STUDY CHARGES AND SUBCOMMITTEE ASSIGNMENTS 5
PENSION OBLIGATION BONDS 6
  BACKGROUND 7
  RISKS FACTORS 8
  CREDIT RATING 9
  CONSIDERATIONS 10
  MASSACHUSETTS LANGUAGE 10
  RECOMMENDATIONS 14
RETURN TO WORK/RETIRE IN PLACE 15
  BACKGROUND 16
  INCENTIVE BONUS/COST SAVINGS 16
  ERS 17
  TRS 17
  TCDRS 19
  TMRS 20
  RECOMMENDATIONS 20
INSURANCE BENEFITS 22
  BACKGROUND 22
  ISSUE ONE 22
  ISSUE TWO 22
RECOMMENDATIONS 23
ENDNOTES 24

INTRODUCTION

At the beginning of the 78th Legislature, the Honorable Tom Craddick, Speaker of the House of Representatives, appointed seven members to the House Committee on Pensions & Investments. The committee membership included the following: Rep. Allan Ritter, Chairman; Rep. Barry Telford, Vice-Chairman; Rep. Ruth McClendon, Chairwoman of Budget and Oversight; Rep. Kent Grusendorf; Rep. Trey Martinez-Fischer; Rep. Aaron Pena, Rep. Patrick Rose.

During the interim the committee was assigned three charges by the Speaker. The Chairman appointed subcommittees to study each of these charges. They are: The Retire In Place/Return To Work Subcommittee; The Pension Obligation Bond Subcommittee; and a general charge to monitor agencies and programs under the committee's jurisdiction and legislation passed by the 78th Legislature which resulted in The Insurance Benefits Subcommittee.

The subcommittees have completed their hearings and investigations and have issued their respective reports. The Pensions & Investments Committee has adopted and approved all subcommittee reports, which are incorporated as the following final report for the entire committee.

Finally, the committee wishes to express appreciation for the assistance and information provided by the following: Ann Fuelberg and William Nail with the Employees Retirement System; Ronnie Jung and Pattie Featherston with the Teacher Retirement System; Ray Henry, Tom Harrison and Jason McElvaney with the Texas County & District Retirement System; Gary Anderson, Ray Spivey and Joel Romo with the Texas Municipal Retirement System; Ginger Smith of the Pension Review Board; Billy Hamilton with the Comptroller's Office; Jody Wright and John Wielmaker of the Legislative Budget Board; Ron Snell with the National Conference of State Legislators; Parry Young with Standard & Poor's; The University of Texas; Texas A&M University; Robert Doherty of UBS Financial Services; the City of Houston; the City of Dallas, the City of San Antonio and the City of El Paso. We also extend our thanks to the public citizens who testified at the hearings for their time and efforts.

HOUSE COMMITTEE ON PENSIONS & INVESTMENTS

INTERIM STUDY CHARGES AND SUBCOMMITTEE ASSIGNMENTS

PENSION OBLIGATION BONDS

CHARGE Examine the feasibility, risks and benefits associated with Pension Obligation Bonds in order to reduce unfunded liabilities in municipal and state retirement systems.

MEMBERS
Patrick Rose - Chairman
Trey Martinez-Fischer - Vice Chairman
Allan Ritter
Barry Telford
Kent Grusendorf
Aaron Pena
Ruth McClendon

RETIRE IN PLACE/RETURN TO WORK

CHARGE Study the risks, benefits and impact associated with the "retire in place" practice as it relates to the Employees Retirement System, Teacher Retirement System, Texas County & District Retirement System and the Texas Municipal Retirement System.

MEMBERS
Aaron Pena - Chairman
Ruth McClendon - Vice Chairman
Allan Ritter
Barry Telford
Kent Grusendorf
Patrick Rose
Trey Martinez-Fischer

INSURANCE BENEFITS

CHARGE Monitor agencies and programs under the committee's jurisdiction and legislation passed by the 78th Legislature.

MEMBERS
Ruth McClendon - Chairman
Trey Martinez-Fischer - Vice Chairman
Allan Ritter
Barry Telford
Kent Grusendorf
Aaron Pena
Patrick Rose

PENSION OBLIGATION BONDS

Pension Obligation Bonds

BACKGROUND

In the 78th Legislative Session, SB 1696 by Senator Wentworth was passed and went into effect September 1, 2003. SB 1696 authorized political subdivisions of the state to pay unfunded liabilities of public pension funds by issuing pension obligation bonds (POB). Nationwide, pension funds are experiencing a rapid growth in unfunded liabilities driven primarily by investment losses, benefit enhancements and greater longevity of pension plan beneficiaries.

Pension obligation bonds are considered a new tool to relieve the pension system's unfunded indebtedness. While a few POB were issued in the 1980s, they truly came into their own in the 1990s with more than $10 billion being sold. The average principal amount for POBs ranged from $100 million to $300 million with a few exceeding $1 billion or more. Over the last 10 years, there have been over 300 POBs issued totaling $38.1billion. Most recently the states of Kansas, Wisconsin and Oregon, and the cities/counties of Allentown (PA), Fresno (CA) and Westchester (NY) have issued POBs.

The POB objective is to fund unfunded pension liabilities as a long-term investment. Using POBs for short-term debt has been compared to using a home equity loan to buy groceries. Bonds are issued by a state or local government that sponsors a pension plan and not by the pension plan itself. Proceeds are deposited in the pension trust fund for investment. The issuing government repays the bonds with general funds.

Standard & Poor's reports, "the goal is for the sponsor to realize savings by paying lower carrying charges for pension contributions and debt service than what is earned by their asset pool. Prior to the POB sale the employer would have been required to make contributions to cover its normal pension costs plus an amount to fund the unfunded accrued actuarial liability (UAAL), an increase in the contribution total. After the sale, the UAAL portion would fall away and be replaced by the lower cost to pay debt service on the POBs."[1] To actually realize a savings, the average annual investment return on pension assets over the life of the POB must be higher than the total interest cost on the POBs. Equaling or beating the pension fund's actuarial investment return assumption is the goal. Historically, this return assumption as been around 8%.

In the 1990s most employers funded the entire UAAL, but for various reasons many now tend to finance less than the full amount. The Cities of Houston, San Antonio and Dallas are examples in Texas that are expected to issue POBs to fund a portion of their UAAL in the near future.

Timing, market conditions and interest rates are key elements in the success of POBs. In the early to mid-1990s, the elements for POBs could not have been better. Returns on domestic equities were sustained at levels well above the historical experience. During this time that POBs were issued, the funding status of the pension funds were increased to fully funded and some even

surpassing the 100% funding mark. Under these circumstances and with their actuaries recommendation, the pension plan sponsors chose to decrease or temporarily eliminate pension contributions. This, in turn, slowed the growth of assets. Some plan sponsors chose to improve employee benefits which instantly increased the fund's liabilities, but also balanced the overfunded status. POBs produced, as promised, an economic benefit and in most cases it was substantial. This, however, lulled the funds into a false sense of security.

RISKS FACTORS

The principle risks to the issuer of the POB fall into a number of categories:

- Arbitrage (Investment return/POB interest cost);
- Leverage;
- Market risk; and
- Political

Arbitrage: POBs are essentially an arbitrage play, the success of which is dependent on the premise that the pension fund assets will earn an average more than the interest cost and investment return rate of the POBs. At the end of the fiscal year 2001, the S&P 500 declined 15.8% (and fell an additional 15% in the next quarter), which was the worst performance since fiscal year 1982.[2] This decline in the market resulted in a below average return (6%) on the plan's assumptions. Weak investment returns catapulted into lower pension funding levels. This in conjunction with increased benefits adopted during their "overfunded status" had catastrophic results. In this case the investment underperformance over an extended period of time, in addition to the benefit changes, lead to actuarial losses and new unfunded liabilities. This resulted in the need to increase contribution rates to bring the systems back into balance. Many funds now use smoothing methods for actuarial purposes in valuing assets to spread investment gains and losses (typically 5 years). In a long-term lower return environment with declining funding levels, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead.[3]

Parry Young with Standard & Poor's used the following example in a November 2001 newsletter to illustrate this problem. *"For example, say a state sold POBs in 1985 with a 30-year amortization to fully fund its retirement system and had average annual investment returns of 12% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the state managed its funding ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If we are, in fact, heading into a lower return period (the average annual increase in the S&P 500 for the 16 years from 1966 to 1892 was a meager 2.7%, for example), the state may have already reaped all its gains from the transaction structure and be headed for losses. If actuarial losses start to be incurred, contributions will have to increase. If returns fall below the interest cost on its POB that will mean that the POB will have become a net financial drain. If investment yields fall below POB interest cost, total debt service, including that on the POB, plus normal and new unfunded actuarial accrued liability (due to low returns) contributions, will now be higher than if the POB had not been sold. To judge the full effect of a POB, however, any future losses have to be weighed against prior period gains. With a POB, its ultimate success, or failure, can only be judged as it's final maturity is*

approached. The financial dynamics may be a winning formula for 25 years, for example, and then a losing one in the last five years (or vice versa)."

Leverage: Adding too much leverage is another factor to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. POBs are a means of substituting one long-term debt for another. Bond debt service must be paid in full and on time or the issue falls into default with wide ramifications (hard obligation). For certain employers, contribution payments may be temporarily deferred or reduced without serious negative consequences (soft obligation).

Market Risk: Because POBs generate very large infusions of funds into the pension system compared with the more steady investment and reinvestment of interest, dividends and contributions by the fund, the plan for investing POB proceeds must be considered.

Political: There is a political risk with POBs. They can become a victim of their own success. As illustrated earlier, should a POB be issued for the full 100% funding ratio and subsequent higher than average returns result in an overfunded status, political pressure to distribute the illusionary "excess" funding by increasing benefits, in turn, incurring new liabilities. Those that fell victim to this overfunded mirage paid the price when the market declined. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success.

CREDIT RATING

Standard & Poor's factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. They focus on the effect of the bonds with regard to the issuer's debt structure and its ability to meet its obligations. POBs are viewed as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage.

Standard & Poor's looks at total debt with and without the POB so as not to penalize a POB issuer in comparison to another issuer that might have relatively low debt (and no POBs), but sizable unfunded pension liabilities. Also, they evaluate the leverage added by the POB. Does it markedly increase hard, fixed costs (bond debt service) in place of a softer more discretionary obligation (pension contributions)? If subpar investment returns put upward pressure on contribution rates will they, coupled with the new higher debt service costs due to the POB, put the issuer's budget under greater strain? The issuer must also be cognizant of the effect the POB issuance may have on statutory debt limits. Will the POB use up debt capacity that might be needed for other, more pressing needs?[4]

From a cash flow standpoint, Standard & Poor's reviews projected debt service and contribution costs, with and without the POB, including the validity of the assumptions including for POB interest costs and pension fund investment returns. How do the projections compare in total and on an annual basis? The spread between interest costs and investment return generates the savings expected from the transaction. The analysis of cash flows is a critical component to

understanding the full impact of the transaction.[5]

A review of the current status of the recipient of bond proceeds - the pension system itself. What is the statutory relationship between the issuer/employer and the fund? How have the laws and precedents for making contributions affected funding progress and how do they play into the POB strategy? Have funding levels generally been increasing over time? What are the funding goals and how will the POB impact these objectives?[6]

The pros and cons of POBs should be weighed very carefully. Risks should be carefully evaluated. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure.

It is possible for POBs to have a negative effect on credit quality. An evaluation is done of each employer's individual profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long-term, but short-term fiscal dislocations resulting from these structures are part of their baggage.

CONSIDERATIONS

In testimony received from the Ron Snell with the National Conference of State Legislators the following recommendations were made:

- Bond issuers should have a capacity for added risk
- Bond issue should not be so large that it limits borrowing for other purposes
- An issue should be no more than about 20% of the pension fund's assets (to limit risk, and facilitate investment).
- Debt service should be in roughly equal annual amounts - POBs should not be used to shift financial problems to the future.

MASSACHUSETTS LANGUAGE

Massachusetts requires local governing boards formally to adopt guidelines and language approved by the town council.

Pension Obligation Bonds
Commonwealth of Massachusetts
Issuance Criteria
April 23, 2004

Recently enacted, as well as pending home rule legislation regarding the use of pension obligation bonds in named communities stipulates that such bonds may be issued only if, at a minimum, a comprehensive plan is first approved by the Secretary for Administration and Finance. To facilitate submissions by relevant municipalities, the Executive Office for Administration and Finance (A&F) promulgates the following guidelines:

1. **A city or town operating its own retirement system:**

a. The local appropriating authority of the city or town must approve the issuance of pension obligation bonds by a two-thirds vote;

b. The following disclosure language must be accepted by a two-thirds vote, in a town, by the board of selectmen; in a city, by the council with the mayor's approval when required by law; and in a municipality having a town council form of government, by the town council:

THE USE OF PENSION OBLIGATION BONDS MAY INCREASE THE POTENTIAL LOSSES ASSOCIATED WITH PENSION FUND INVESTMENTS. THE COMMONWEALTH IS NOT RESPONSIBLE FOR ANY LOSSES INCURRED BY A MUNICIPALITY DUE TO THE ISSUANCE OF PENSION OBLIGATION BONDS, NOR FOR ANY INCREASE IN UNFUNDED ACTUARIAL ACCRUED LIABILITY DUE TO DEFICIENT INVESTMENT RETURNS.

2. Approval by the Executive Office for Administration and Finance

a. With regard to cities and towns with credit ratings of "Aa3/AA-" or higher, A&F will ascertain to its satisfaction that:

i. Credit Ratings

1. The city or town is rated by at least two nationally recognized rating agencies;

2. The city or town's credit rating will not decline below the "Aa3/AA-" category as a result of the issuance of pension obligation bonds.

ii. Pension Obligation Bond Structuring

1. The pension obligation bonds will have a final maturity no later than 2028;

2. The debt service associated with the pension obligation bonds for the first three fiscal years subsequent to their issuance will be at least equal to the minimum payments required by an amortization schedule

that fully funds the unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year.

iii. Present Value Savings

1. A pension obligation bond issue is projected to generate net present value savings;

2. Present value cash flow savings will be measured as the difference between debt service payments for the pension obligation bonds and the payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year;

3. The discount rate will be the true interest cost of the pension; obligation bond issue, including all premiums, discounts, fees, insurance cost and other expenses.

iv. The city or town has complied with guideline 1(b) above.

v. A&F will issue an approval letter to the city or town upon proof of compliance with guideline 2(a) i-iv.

b. With regard to cities or towns with credit ratings lower than “Aa3/AA-”, but higher than “Baa2/BBB” A&F will ascertain to its satisfaction that:

i. Credit Ratings

1. The city or town is rated by at least two nationally recognized investor rating agencies;

2. The city or town’s credit rating will not decline as a result of the issuance of pension obligation bonds.

ii. Pension Obligation Bond Structuring

1. The pension obligation bonds will have a final maturity no later than 2028;

2. The debt service associated with the pension obligation bonds for the first five fiscal years subsequent to their issuance will be at least equal to the minimum payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year.

iii. Present Value Savings

1. A pension obligation bond issue is projected to generate net present value savings;
2. Present value cash flow savings will be measured as the difference between debt service payments for the pension obligation bonds and the payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year;

3. The discount rate will be the true interest cost of the pension obligation bond issue, including all premiums, discounts, fees, insurance cost and other expenses.

iv. Financial Capacity

1. A city or town must possess the financial capacity to address additional unfunded liabilities that may arise should returns on pension assets be below the assumed rate of return;

2. A&F's analysis will include, but not be limited to the following:

a. Tax levy capacity
b. Reserves
c. Debt levels
d. Management

v. Pension Fund Historical and Projected Return Performance

1. The city or town's historical rate of return on its pension fund over the prior 10-year period must be equal to or greater than its current rate of return assumption.

vi. Pension Fund Management

1. The retirement system's pension assets must be managed by PRIM or by a nationally recognized asset management company;

2. The city or town must provide an asset allocation plan for the proceeds of the pension obligation bond to A&F and PERAC.

vii. Subsequent to A&F Approval:

1. The city or town must provide A&F with the value of its pension fund on a "mark-to-market" basis no earlier than 60 days prior to the issuance of pension obligation bonds;

2. The city or town will conduct an actuarial valuation of its pension

assets once every year and report its findings to both A&F and PERAC. If the actuarial valuation of pension assets is less than projected pension liabilities, the city or town must fund this deficiency based upon a PERAC approved schedule.

c. City or towns with credit ratings below ""Baa1/BBB+" will not receive written approval from A&F to issue pension obligation bonds.

d. Notwithstanding any provision herein to the contrary, A&F reserves the right to disapprove any request for the issuance of pension obligation bonds; A&F further reserves the right to require the submission of any materials or information it deems necessary for its determination or to waive any requirement listed above.

RECOMMENDATIONS

In an effort to protect the state, cities and counties from the possible dangers associated with the issuance of POBs, it is the Committee's recommendation that the State of Texas follow the example of the State of Massachusetts in adopting similar guidelines. The Committee believes this language is not a cure-all and strict scrutiny needs to be given to each and every actuarially unfunded pension system before POBs are issued. However, the language of the State of Massachusetts will serve as a starting platform from which we can begin.

RETURN TO WORK/RETIRE IN PLACE

RETURN TO WORK/RETIRE IN PLACE

BACKGROUND

Nationwide people are retiring and returning to work. Texas is only one of many states in which a person can retire from work and be reemployed by the same entity. Two terms are used for this practice: Return to Work and Retire in Place.

Return to Work (RTW) is when an employee reaches retirement qualifications and takes their retirement. They then return to work for the same agency, but in a different position. Retire in Place (RIP) is a case in which the person has reached retirement eligibility and retires, but remains working in their same job. Each person begins receiving an annuity check from the retirement system and receive a check from the agency they are working for. In Texas, our public pension systems have varying degrees of RTW and RIP programs.

There was a time when retirement meant you retired from the agency and could not return. Money managers and investment advisors nationwide began advising people to retire at first eligibility and go back to work elsewhere. It was a way to make the most of their income status. This practice became commonplace. Employers, however, began to suffer because they were losing valuable expertise and knowledge with each retirement. States began passing legislation to help alleviate the loss of this institutional knowledge. Texas followed suit and presently each pension system; the Employees Retirement System (ERS), the Teacher Retirement System (TRS), the Texas County and District Retirement System (TCDRS) and the Texas Municipal Retirement System (TMRS), have some form of Return to Work.

INCENTIVE BONUS/COST SAVINGS

Texas not only has a RTW program, but in the 78th Regular Session, legislation was passed offering a generous retirement incentive bonus. Beginning in 2003, if an employee of the state retired at their first eligible date, they would receive 25% of their annual salary as a bonus. Nationwide this is one of the most generous retirement incentives offered. This incentive is good through 2005.

In the agency funding process, the agency would only receive 65% of the retiree's salary thus causing the agency to hire a replacement at a lesser cost. This, of course, would generate a cost savings for the state. However, the Comptroller did not anticipate the number of people that would take the incentive bonus. In FY 2001 ERS had 3459 retirees and in FY 2002 had 4372 retirees. During the incentive period of FY 2003, 8172 state employees retired with 4794 receiving the incentive bonus. For FY 2004, the number of new retirees is projected at 4594 with a projected 2318 receiving the incentive bonus. The Comptroller submitted information stating that:

1. Retirement incentive bonuses paid in fiscal year 2004 will realize savings from salaries budgeted for 2004 and 2005.

2. There will actually be a net loss in fiscal year 2005 because there will be a point in the year when the 35% of the remaining budgeted salaries will not be sufficient to cover the cost of the bonus payments.

3. A retirement incentive bonus may be paid initially from General Revenue (GR) and then be recovered through agencies' federal indirect cost plans. The total GR savings will be reduced by the amount of bonus payments not recovered. It is our understanding at this time that the Federal DHS will allow the inclusion of the retirement bonus payment as a reimbursable cost. It is estimated that retirement incentive payments for retiring employees paid with federal funds is $16.5 million.

For ERS, RTW has a two-fold cost savings. Usually the retiree goes back to work for the state at a lesser salary resulting in a cost savings. Also, the state does not have to match a 6% pension contribution resulting in a savings. The active employee is covered under the same state-paid insurance program as the retiree, so there is no extra cost to the system. It needs to be noted, that while the state is not having to pay the 6% pension contribution, the employee is also not paying that contribution into the fund. The state may be realizing a savings by paying a lesser salary, but the pension system is paying a retirement annuity without being replaced by another person who would make active contributions. Presently there has been no evidence that the pension system has been adversely affected.

ERS

The number of RTW retirees has increased more than 400% since the Legislature lifted annuity restrictions and salary caps in 2001 as the result of an E-Texas Performance Review recommendation. Retirees must remain off of a state payroll for one month prior to being rehired. As of May 1, 2004 the Comptroller reported 3230 RTW retirees on agency payroll - - 1289, or 40% of those have been reported since the incentive period began.

Current RTW policy has reduced administrative difficulties for ERS since the System is no longer required to track suspended annuity payments for RTW retirees. Before 2001, ERS actuarial assumptions did not anticipate the employment of any ERS retirees since the numbers were too negligible to have an impact on the trust. ERS currently monitors the total number of RTW retirees through the Comptroller's office to determine if the practice is influencing the number of state employees retiring at first eligibility and will recommend changes to the actuarial assumptions as needed.

TRS

Each public pension system has their own rules regarding return to work. ERS and TRS are presently the only systems that allow the retiree to return to the same entity. TRS is different in that their RTW program could end up costing the system money because of the structure of their insurance program. The funding for the teacher active and retiree insurance programs are

different. The active employee's program (ActiveCare) is funded by contributions of $150 a month by the local school district and $75 per month by the state with the employee paying the remainder. Less than half of the school employees are members of ActiveCare. Most are covered under a spouses policy. The retiree insurance program (TRS-Care) is funded with the school districts paying .4% of payroll, the state paying 1% of payroll and the retiree paying a premium. When a retiree is added into TRS-Care, the funding has to either come from the state or by higher retiree premiums. The funding mechanism does not correlate to the program structure by basing retiree insurance contributions to active payroll.

Before September 1, 2004, a teacher became retirement eligible with at least 10 years of service, five of which could be purchased as out-of-state service. After September 1, 2004, retirement could occur at normal retirement age (the Rule of 80) with at least 10 years of service, five of which may be purchased military service. Special service purchases other than military (out of state service and air time) may not count toward eligibility in the TRS-Care program. A retiree that does not meet the insurance eligibility requirements may participate by paying the full cost until age 65.

The RTW program for TRS is structured with conditions to slow the return to work so that it does not present a strain on the retirement fund. The basic premise of TRS law disallows return to work in school positions, however, numerous exceptions exist that give employees opportunities to collect both a retirement benefit and salary. A teacher may return to work if the school district has been deemed an acute shortage area and the teacher has a 12-month break in service. Also, immediate return can occur if the teacher is hired as a substitute, working half-time or full-time up to six months. A principal or assistant principal may return full-time after a 12 month break in service and bus drivers with no restrictions. All retirees who retired prior to January 1, 2001 may return with no restrictions.

In an effort to edge around the restrictions for RTW, third party entities were created in which the teacher is hired through their firm and then placed in schools. The teacher becomes an employee of the firm and not the school district so returning to work was not in violation of the law. This provided a loop-hole in the law which was corrected by HB 2169 in 2003. This bill stipulates that employees of third party entities will be subject to the same restrictions as other school employees, if they are performing duties typically done by a regular school employee. It allowed those who were employed by the third party entity prior to May 24, 2004 to continue their employment with a grandfather clause.

Retirement rates have increased rapidly within TRS in recent years. Use of the RTW program are also increasing. There are presently 200,000 TRS retirees and 860,000 active employees. Of the active number, 100,000 are presently eligible to retire. In recent years the number of retirees has been:

2003 - 19,635 retired
2002 - 16,615 retired
2001 - 14,304 retired

Approximately 18,500 use the return to work exceptions. This number is broken down as

follows for returning teachers serving as:

Substitutes - approximately 3100 per month
Half-time - approximately 3100 per month
Full time up to six months - approximately 4500 per month
Those exceeding 6 months experienced loss of annuity beginning in March, 2004
compared to 2000 annuities affected in March 2003.
Classroom teachers in acute shortage areas - approximately 280 per month
Principal and assistant principal - approximately 59 per month
Bus drivers - approximately 440 per month

TCDRS

The TCDRS is different from both ERS and TRS in that it is a multi-employer plan. Counties and districts are eligible to participate in TCDRS. The RTW program in TCDRS is more restrictive than the two state plans. TCDRS retirees are not allowed to return to employment with the entity they retired from without an annuity suspension. They are allowed to go to work for another county, district or taxing authority. By returning to another entity other than the one they retired from allows the retiree to receive their annuity check as well as a salary. Should the person decide to return to work for the same employer, their annuity check is suspended. Upon termination of second employment with the same or different employer, the employee has the option to withdrawal of personal contributions and interest or an additional annuity.

Employers (particularly large urban counties) have placed themselves at a competitive disadvantage for their own employees by attempting to provide a good benefit and early retirement. Persons returning to work with the same employer are treated differently than a person that returns to work with any other employer. Payment of suspended annuities in a lump sum at the end of the second employment period can have adverse tax implications. Frequently, the reemployment is in a reduced capacity (but one resulting in the temporary loss of the annuity payments) can result in a sharp reduction in total current income and a lost opportunity for both the employee and employer. The decision to retire is not always well founded; therefore, disallowing return to work eliminates what may be the person's best option for rectifying a poor decision.

An employer has little control over a person's decision to retire, but complete control over who they hire in appointed positions; therefore, disallowing RTW with the same employer also eliminates the opportunity for the employer to recapture critical skills and experience should the employer choose. The current provisions are encouraging employers and retirees to figure a way around the existing process in order to accomplish something that is in both their interest and probably in the interest of the public.

As long as all annuitants returning to work (regardless of whether the reemployment is with the same employer or not) are required to participate , there is negligible monetary impact on the employer or TDCRS. Generally speaking, such actions tend to reduce the total benefits

that will ultimately be received by the member; however, there are circumstances where it can be in the best interest of themselves or their dependent, which make it inappropriate for their use to be judged without the particular facts and circumstances. For the employers, the cost of funding benefits is not likely to be significantly impacted. For the employees, the loss of total benefits and additional required contributions are unlikely to be a significant issue.

TMRS

TMRS is a statewide, multi-employer system that provides retirement, disability retirement, and death benefits for most of the city employees in Texas. Presently, there are 796 cities that elect to participate in TMRS. Each system in TMRS is a separate plan, on both an actuarial and funding basis.

TMRS is the same at TCDRS in that returning to work for the same entity is prohibited without suspension of annuity payments. The returning retiree is required to "rejoin" TMRS and make monthly member contributions. Upon the second retirement, TMRS will resume payment of the original monthly retirement benefit. The retiree also receives an annuity for the second employment.

If a TMRS retiree goes to work for a TMRS city that was not his employer when he retired, he is required to make member contributions to TMRS. His original retirement benefit is not affected. In effect, the retiree is joining a new city that has its own separate plan under TMRS. When he later terminates this new period of employment, the person will receive a monthly retirement benefit based on member contributions, city matching funds and other credits from the new period of employment.

RECOMMENDATIONS

The RTW and RIP programs within the pension systems appears to be a positive option for employees. Each system has its own restrictions and eligibility requirements. The committee recommends the following:

- ERS - continue with the current RTW/RIP plan
- TRS - continue with the current RTW/RIP plan with careful consideration to the insurance funding and possible costs to the state.
- TCDRS - elevate their current RTW program to allow a retiree to return to the same entity they retired from
- TMRS - elevate their current RTW program to allow a retiree to return to the same entity they retired from

With elevating the TCDRS and TMRS plans, we will have all pension systems with essentially the same standards. Monitoring the RTW/RIP programs within each fund should be carefully performed to ensure the fund is not adversely affected. Any negative experience to the funds due to RTW or RIP should trigger immediate steps to correct the problem.

INSURANCE BENEFITS

INSURANCE BENEFITS

BACKGROUND

The state's Employee Retirement System (ERS) was created to provide retirement, death, and disability benefits to state employees through the Texas Employees Uniform Group Program (UGIP). Coverage and benefits were also extended to the judiciary and employees of some higher education institutions. It has always been a priority of the legislature to protect and provide for this program as a benefit to the employees of the State of Texas. With higher salaries in the private sector, the state insurance program was one of the added enticements to hire qualified people. Over the last few years, it has been necessary to cut back on the insurance plan to eliminate costs. Rising costs of health care is of great concern to the state as it is nationwide. The program has been cut to what many consider to be "the bare bones." Of the changes made, two issues stand out as needing to be addressed.

ISSUE ONE

In an effort to preserve the UGIP the state has always protected the plan from outside entities from participating. The thought was to keep the program in tact so that there were not differing benefits and requirements for the same group of people. Also, a precedent would be set and many outside entities would try to be included in the program. A group that has tried for many years to cross over into the UGIP are probation officers. During the last legislative session they finally accomplished their quest with HB 725. HB 725, effective September 1, 2004, now extends the state's UGIP to include county supervision and correction department employees and their dependents. This has caused differing qualifications for the same benefit. It creates a disparity in the program and while state employees are required to follow one set of requirements, the probationers are following a lesser set of requirements.

An Attorney General's letter was issued that required ERS to allow the probation employees to retire and receive their insurance benefits earlier than a state employee would. Local community supervision and corrections departments (CSCDs) are not state employees and participate in the Texas County and District Retirement System. CSCD employees adhere to the benefits and guidelines of their respective county.

ISSUE TWO

Higher education employees (state funded institutions) are also covered under the UGIP. In years past A&M and the University of Texas were carved out so that they could run their own state funded insurance program. This creates disparity within the higher ed benefits. The UGIP was cut back during the 78th Regular Session to require someone to retire with 10 years of service to rise from 60 to 65. The retiree may retire at age 60, but cannot begin to receive their insurance benefit until age 65. A & M and the University of Texas were grandfathered out of this cut back causing another disparity in the UGIP as well as with other state-funded universities.

. The intent of the Legislature was for all state funded insurance programs to have the five year waiting period to recoup costs of rising health care. This cut was severely felt by many that were on the cusp of reaching 60. Also, many feel the cut went too far. As mentioned earlier, the insurance benefit (as well as retirement benefit) was supposed to be an incentive for choosing state employment and receiving a lesser salary. If the state continues to cut those benefits, the employee feels taken advantage of and cheated. These employees have dedicated their working years to the state and are getting less bang for their buck in all aspects.

An Attorney General's Letter was issued stating that A&M and UT could grandfather their employees because the bill that allowed this passed after the bill that required the rise in age.

A person who takes their retirement at age 60 with 10 years of service is eligible for COBRA coverage (18 months). After COBRA has been exhausted the retiree has access to the UGIP, but must pay all actuarial costs. These are quite expensive:

Monthly Rates:

Retiree Only $835	**Retiree and Spouse $1794**
Retiree and Child(ren) $1477	**Retiree and Family $2436**

These premiums would be tremendously difficult to pay for a person on a fixed income. Many view this as unfair because many current state employees vested with the knowledge of the ability to retire with insurance benefits at age 60.

RECOMMENDATIONS

The committee feels that the addition of the probation officers to the Texas state employees insurance program is detrimental to the fund and moral of the state employees. The committee recommends legislation be enacted that would remove the county probation departments from the state insurance program.

Also, it is the opinion of the committee that the state return to the age of 60 and 10 years of service for ALL that are covered under the UGIP. State employees have not been treated fairly with the many cuts and restoration of this benefit would be a step in the right direction. The state previously funded this benefit and would cost approximately $15 million. This money should not be viewed as "new money" needed, but paying for a benefit that should still be in existence.

ENDNOTES

[1] Standard & Poor's, Public Finance Publication, Nov-2001
[2] Standard & Poor's, Public Finance Publication, Nov-2001
[3] Standard & Poor's, Public Finance Publication, Nov-2001
[4] Standard & Poor's, Public Finance Publication, Jan-2004
[5] Standard & Poor's, Public Finance Publication, Jan-2004
[6] Standard & Poor's, Public Finance Publication, Jan-2004