HOUSE COMMITTEE ON PENSIONS AND INVESTMENTS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2000

A REPORT TO THE
HOUSE OF REPRESENTATIVES
77TH TEXAS LEGISLATURE

SHERRI GREENBERG
CHAIR

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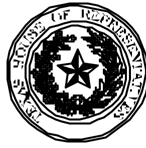

Committee On
Pensions and Investments

November 28, 2000

Sherri Greenberg
Chair

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

The Honorable James E. "Pete" Laney
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 and Investments of the Seventy-Sixth Legislature hereby submits its interim report including recommendations for consideration by the Seventy-Seventh Legislature.

Respectfully submitted,

Sherri Greenberg, Chair

Dale B. Tillery, Vice Chair

Dennis Bonnen

Ron Clark

Kenn George

Irma Rangel

Ignacio Salinas, Jr.

Barry Telford

Thomas “Tommy” Williams

Dale B. Tillery
Vice-Chairman

Members: Dennis Bonnen, Ron Clark, Kenn George, Irma Rangel, Ignacio Salinas, Jr., Barry Telford, Thomas “Tommy” Williams

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INTRODUCTION

At the beginning of the 76th Legislature, the Honorable James E. “Pete” Laney, Speaker of the Texas House of Representatives, appointed nine members to the House Committee on Pensions and Investments. The committee membership included the following: Sherri Greenberg, Chair, Dale B. Tillery, Vice Chair, Dennis Bonnen, Ron Clark, Kenn George, Irma Rangel, Ignacio Salinas, Jr., Barry Telford, and Thomas “Tommy” Williams.

During the interim, the Committee was assigned five charges by the Speaker. In order to undertake the charges efficiently and effectively, Chair Greenberg appointed subcommittees to study the charges.

The subcommittees have completed their hearings and investigations and have issued their respective reports. The Pensions and Investments Committee had adopted and approved all subcommittee reports which are incorporated into this final report.

Finally, the Committee wishes to express appreciation for the time and efforts dedicated to helping address these charges by the Employees Retirement System, Teacher Retirement System, Texas County and District Retirement System, Texas Municipal Retirement System, Fire Fighters Pension Commission, State Pension Review Board, and the State Securities Board. In addition, the Committee thanks Leon “Rocky” Joyner, Jr., Matthew Lathrop from the American Legislative Exchange Council, Ronald Snell from the National Conference of State Legislatures, Texas Retired Teachers Association, Association of Texas Professional Educators, Texas Association of School Administrators, Texas Federation of Teachers, Texas Classroom Teachers Association, Texas State Teachers Association, Texas State Employees Union, Texas Public Employees Association, Texas Association of Public Employees Retirement Systems, Texas Higher Education Coordinating Board, Texas Education Agency, State Board for Educator Certification, Jimmy Perez from the House Committee on Pensions and Investments, and the many citizens who testified and provided information on matters before the committee.

HOUSE COMMITTEE ON PENSIONS AND INVESTMENTS

INTERIM STUDY CHARGES AND SUBCOMMITTEE ASSIGNMENTS

LOCAL RETIREMENT SYSTEMS

CHARGE Review the adequacy of the state's monitoring of local retirement systems.

Dale Tillery, Chair
Kenn George
Irma Rangel
Ignacio Salinas, Jr.
Thomas "Tommy" Williams

DEFINED CONTRIBUTION / DEFINED BENEFIT

CHARGE Evaluate the pros and cons of defined contribution retirement plans that do not guarantee members any specific level of benefits upon retirement. Plans adopted in other jurisdictions should be considered and compared with Texas' state plans in regard to their ability to provide security to retirees, cost, and fairness to diverse employee groups.

Sherri Greenberg, Chair
Kenn George
Barry Telford
Irma Rangel
Ignacio Salinas, Jr.
Thomas "Tommy" Williams

RE-EMPLOYMENT

CHARGE Consider a general policy for the state regarding the re-employment of people who have retired under a state retirement plan.

Dennis Bonnen, Chair
Kenn George
Sherri Greenberg
Ignacio Salinas, Jr.
Dale Tillery

ANNUITY OPTIONS

CHARGE Review the need for multiple cash and reduced annuity options such as lump sum and "DROP" plans.

Ignacio Salinas, Jr., Chair
Dennis Bonnen
Ron Clark
Barry Telford
Dale Tillery

OVERSIGHT SUBCOMMITTEE

CHARGE Conduct active oversight of the agencies under the committee's jurisdiction.

Ron Clark, Chair
Dennis Bonnen
Sherri Greenberg
Dale Tillery
Thomas "Tommy" Williams

LOCAL RETIREMENT SYSTEMS

LOCAL RETIREMENT SYSTEMS

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with reviewing the adequacy of the State's monitoring of local retirement systems. In Texas, the agency that works with local retirement systems is the Pension Review Board.

The Pension Review Board (PRB) was created by the 66th Legislature in 1979 with the passage of House Bill 1506. The PRB is an independent state agency designed to oversee and review state and local public retirement systems in Texas. The Board is composed of nine members. The Governor appoints seven of these: three persons who have experience in the fields of securities investment, pension administration, or pension law and are not members or retirees of public retirement systems; one active public retirement system member; one retired public system member; one person who has experience in the field of governmental finance; and an actuary. The Lieutenant Governor appoints a State Senator and the Speaker of the House appoints a State Representative.

Specifically, Section 801.202 of the Texas Government Code charges the PRB with four general duties:

1. conducting a continuing review of public retirement systems, compiling and comparing information about benefits, creditable service, financing, and administrations of systems;

2. conducting intensive studies of potential or existing problems that threaten the actuarial soundness of or inhibit an equitable distribution of benefits in one or more public retirement systems;

3. providing information and technical assistance on pension planning to public retirement systems on request; and

4. recommending policies, practices, and legislation to public retirement systems and appropriate governmental entities.[1]

Prior to the creation of the PRB, the House Interim Committee on Public Pension Plans found that a number of local pension systems faced the possibility of being unable to pay promised benefits to their employees. In addition, there was a concern that if the State failed to oversee public pension plans, the federal government would step in and regulate them. As a result, the Interim Committee recommended the creation of the PRB.[2]

Today there are 350 public retirement systems registered with the PRB. Of these, 238 cover paid public employees, and the remaining 112 are local systems for volunteer fire fighters.[3] The retirement systems registered with the PRB serve approximately 1.3 million active employees and 286 thousand annuitants. The total assets of public retirement systems in Texas exceeds $122 billion.[4]

Texas Government Code, Chapter 801, defines a public retirement system as a continuing, organized program of service retirement, disability retirement, or death benefits for officers or employees of the state or a political subdivision, or of an agency or instrumentality of the state or a political subdivision, and includes the optional retirement program governed by Chapter 830.

The majority of systems in Texas are locally controlled, although state law has administrative guidelines for all systems, and the largest plans are under direct statutory control of the State. Local retirement funds in Houston, Dallas, Austin, San Antonio, and El Paso are covered by specific state laws and firefighters throughout Texas belong to local funds operating under the Texas Local Fire Fighter Retirement Act (TLFFRA) or the statewide Emergency Services Personnel Fund.[5]

PRB Guidelines for Actuarial Soundness

In reviewing local plans for actuarial soundness, the PRB has five guidelines:

1. The funding of a pension plan should reflect all plan liabilities and assets.
2. The allocation of the normal cost portion of contributions should be level as a percent of payroll over all generations of taxpayers.
3. Funding of the unfunded actuarial accrued liability should be level or declining as a percent of payroll over the amortization period.
4. Funding should be adequate to cover the normal cost, and to amortize the unfunded actuarial accrued liability over a period which should never exceed 40 years, with 25-30 years being a more preferable target. (ERS and TRS have 31-year amortization limits set in their statutes.)
5. The choice of assumptions should be realistic and reasonable in the aggregate.[6]

Based on these guidelines, the vast majority of local public pension funds are sound. In its 1997-98 biennial report, the PRB notes that ninety-nine percent of defined benefit plans have amortization periods under 40 years, and the few which do not are aware of the problem and are working with the Pension Review Board for a solution. However, a few recent examples of underfunding prompted the committee to examine whether there is adequate oversight of local public pension plans.

The Dallas Employees Retirement Fund (DERF) Case Study

Pension Fund Summary

The DERF, a defined benefit plan, was first formed in 1944. As of December 31, 1998, the fund had 8,268 active members and 4,048 retired members. Contributions to the fund are made up of a combination of City contributions, employee contributions, and investment income. Prior to the adoption of the recent changes in the Dallas Employees Retirement Fund, employees contributed 5 percent of their wages and the City of Dallas contributed 8.5 percent to the fund.

The fund has a rule of 78 benefit, which allows employees who are at least age 50 to retire when their combined age and years of service equal 78. Employees vest after five years of contributing to the Fund. In addition, the plan offers a disability retirement pension, death benefits, and cost of living adjustments.

Summary of Funding Problem

In 1995, after reviewing the actuarial valuation submitted to the PRB, the Board placed the Dallas Employees Retirement Fund (DERF) on a "watch list." The valuation indicated that the amortization period for DERF had reached an infinite level. (Typically a 40 year amortization is acceptable. Statute requires the Teacher Retirement System and the Employees Retirement System to maintain a 30 year amortization). The actuarial evaluation revealed an 8.8 percent shortfall (21 million annually) in the contribution rate. As a result, future benefits for DERF members were in jeopardy unless contributions were increased.[7]

Questioning the findings of the 1995 actuarial valuation which had been conducted by Towers Perrin, the Dallas Employees Retirement Fund contracted with Milliman & Robertson to review the report. Milliman & Robertson upheld the actuarial findings in the Towers Perrin Report.[8]

In mid-1996, the Chair of the City of Dallas Employees Retirement Fund requested a formal evaluation of the actuarial status of the fund. At approximately the same time, the Dallas City Manager hired yet another actuarial firm, Conrad Siegel, Inc., to review the recent Towers Perrin actuarial report. Conrad Siegel, Inc. concluded that the fund was strong financially and recommended a 9.2 percent interest rate assumption - an assumption significantly higher than in other Texas funds. (The Employees Retirement System and the Teacher Retirement System both assume an 8.0 percent interest rate). Another actuary, Alexander & Alexander Consulting Group, was hired by the City Manager to review the work of Towers Perrin and the Siegal report. Alexander & Alexander concurred with the findings of Conrad Siegal, Inc.

In December 1996, the PRB began a review of the actuarial valuations and other work of the actuaries. In June 1997, the PRB issued a report which substantiated the findings in the initial 1995 actuarial valuation conducted by Towers Perrin.

Despite the preponderance of evidence that there was a problem with the long-term viability of the fund, in March 1997, the PRB received a letter from the City Manager's Office stating that the City did not believe that it was necessary to increase contributions or reduce benefits. The City Manager's Office also indicated that addressing any shortfalls would be the DERF Board's responsibility. This sentiment was reiterated at a June 11, 1997 PRB Meeting by Mary Suhm, Dallas' Assistant City Manager.

In December 1998, after several years of wrangling about the existence of the funding problem, the city, under the direction of a new City Manager, and the DERF board appointed a working group to review funding issues and to generate recommendations. In September 1999, after extensive analysis, the working group concluded that a long-term funding problem did exist. The working group recommended that the first priority be given to funding normal and administrative costs through increases in employee and employer contributions. They recommended that the city increase its contributions by 2.5 percent and employees increase their contributions by 1.5 percent gradually over two years.[9]

The recommended change in employees' contributions would have to be approved by 75 percent of the City's civilian employees voting in an election. The increase in the city's contribution would have to be approved by the Dallas City Council. If either the city or the employees failed to approve the proposed contribution increases, the working group recommended that retirement benefits for future retirees be reduced to make up for the shortfall.[10]

The Dallas City Council voted in September 1999 to increase the city's contribution from 8.5 percent of annual civilian payroll costs to 11 percent. A few months after the Dallas City Council vote, an election was held for city workers. On Friday, January 7, 2000, the Dallas Morning News reported that 92 percent of the workers who voted in the mail-in election approved the increased contributions. About 45 percent of the eligible voters participated in this election. As a result of the election, employee contributions increased from 5 percent to 6.5 percent of their salary. Increases are to be phased in over a two year period. Another vote, which will come before all Dallas voters no later than 2002, will decide on automatic adjustments to the contribution rates in the future.[11] Voter's adoption of this proposal should make resolution of any future funding problems easier.

The El Paso Firemen and Policemen's Pension Fund Case Study

Pension Fund Summary

The Firemen and Policemen's Pension Fund has 1,680 active members and 975 retirees and beneficiaries currently receiving benefits. Normal retirement occurs when employees reach age forty-five with at least twenty years of service. The pension benefit is equal to 2.75 percent of final compensation times the number of years of service, not to exceed 77 percent of final compensation. Annual cost-of-living adjustments (3 percent compounded annually) are provided to retired firefighters at the earlier of age 60 or five years after retirement and to retired police officers at the earlier of age 60 or two years after retirement.

Contributions to the Firemen and Policemen's Pension Fund are derived by a combination of City contributions, employee contributions and investment income. Firefighters contribute 12.99 percent of pay and police officers contribute 10.11 percent of pay. The City currently contributes 18 percent of pay, the maximum allowed under City Charter.

Investment returns over the past one, three, and five years have averaged 11.5 percent, 12 percent, and 14 percent, respectively. The Firemen and Policemen's Pension Fund's total assets were approximately $457 million in June 1999. Current asset allocation is 25 percent large cap domestic equity, 15 percent small cap domestic equity, 20 percent international equity, 5 percent emerging markets equity, 25 percent domestic core fixed income, 5 percent high yield bonds, and 5 percent international fixed income.

Summary of Funding Problem

The Pension Review Board has been monitoring the actuarial condition and funding of the El Paso Firemen and Policemen's Pension Fund since 1992. After the September 1, 1994 actuarial valuation of the Firemen and Policemen's Pension Fund revealed an inadequate financing arrangement, the Pension Review Board contacted the Firemen and Policemen's Pension Fund and requested that they develop a

plan to correct the under-funded status. The Pension Review Board also informed the Firemen and Policemen's Pension Fund that state law required the members of the pension fund be notified of the financial status and the inadequate funding of the plan.

Although the Firemen and Policemen's Pension Fund adopted new investment strategies to achieve higher investment returns, subsequent actuarial valuations in 1996 and 1998 indicated that the plan continued to have a contribution rate shortfall and the amortization period remained at infinity. The 1998 actuarial valuations revealed that contributions to the Policemen's Pension Fund would need to increase by 3.46 percent of pay (approximately $1.3 million) and contributions to the Firemen's Pension Fund would need to increase by 9.01 percent of pay (approximately $2.1 million) to pay $110 million in unfunded actuarial accrued liabilities within a 40-year period. Fortunately, the Firemen and Policemen's Pension Fund has enough money to pay benefits to those people who are already retired. However, it is not taking in enough money to pay the current level of benefits to future retirees.

The Firemen and Policemen's Pension Fund is a public pension plan that is governed by state law (Article 6243b, Vernon's Texas Civil Statutes). This law gives the Board of the Firemen and Policemen's Pension Fund the authority to modify retirement benefits and contribution rates with the approval of the majority of active members. In September of 1999, the membership rejected proposals by the Firemen and Policemen's Pension Board to increase employee contribution rates or to make benefit changes that were intended to address the plan under-funding.

In November of 1999, the Firemen and Policemen's Pension Fund contacted the Pension Review Board requesting assistance in developing a strategy to address the under-funded status of the plans. In April 2000, PRB Chair Craig Goralski, and PRB members Shad Rowe and Leonard Cargill met with El Paso Mayor Carlos Ramirez and the El Paso Firemen and Policemen's Pension Fund Board to address the fund's current underfunding and future insolvency if the problems remain uncorrected.

Following the April meeting with PRB Members, El Paso Mayor Carlos Ramirez appointed five individuals to a panel to review the Firemen and Policemen's Pension Fund. This panel, however, includes no representatives from the Fund's Board. They began meeting in mid-July. Despite this important step, to date, this situation remains unresolved.

Analysis of the Problem

The issue before the committee is whether examples such as what occurred in Dallas and El Paso represent a failure of the Pension Review Board to carry out existing state policy, or if additional authority is necessary for the Pension Review Board to prevent these situations in the future. It is helpful to review the current requirements to determine if they are adequate.

Reporting Requirements of Local Retirement Systems

Currently, public retirement systems in Texas face the following requirements:

Registration of Local Funds with the PRB

Each public retirement system must register with the Texas State Pension Review (PRB) within 90 day of the system's creation. The PRB provides registration forms on request. Registration includes: the name, mailing address, and telephone number of the system; names and occupations of the chairman and other members of its governing body; a citation of the state or local law under which the system

was created; the beginning and ending dates of its fiscal year; name, mailing address, and telephone number of the system administrator. (Sec. 802.105)

A system is required to notify the PRB of any changes in this information within 30 days of the effective date of the changes.

Summary Plan Description (Plan design)

A copy of the plan design, as submitted to members of the retirement system, must be on file with the PRB. The PRB must be notified of any changes in plan design within 270 days of adoption. (Sec.802.106)

Annual membership report

The report must show the number of members and pension recipients, including persons receiving survivors' benefits. It is due within 210 days of the end of the system's fiscal year. (Sec.802.104)

Annual financial report

The accounts of each system must be audited at least annually by a certified public accountant in accordance with generally accepted accounting standards. A report showing the financial condition of the system on the last day of its fiscal year must be submitted to the PRB. This report must include the financial statements and schedules examined in the most recent audit and a statement of opinion by the auditor as to whether or not the financial statements and schedules are presented fairly and in accordance with generally accepted accounting principles. Due within 210 days of the end of the system's fiscal year. (Sec. 802.103)

(Firemen's Pension Plans operating under VACS Article 6243e (Texas Local Fire Fighters Retirement Act) with total assets under $50,000 may satisfy this requirement by submitting a copy of the annual report required by the Firemen's Pension Commissioner.)

Actuarial valuation

An actuarial valuation of each system is required at least every three years. Copies of each valuation and any actuarial report must be submitted to the PRB. (Sec. 802.101)

Summarized information

When a person becomes a member of a retirement system, the system must provide:

- a summary of plan benefits and procedures for claiming them; and
- a summary of provisions for employer and employee contributions, withdrawal of contributions, and eligibility for benefits; including any right to terminate employment and retain eligibility.

In addition, each system must provide to each active member:

- an annual statement of the amounts of the member's total accumulated contributions and total accumulated service credit;
- a summary of the financial condition of the system if the actuary finds the financing arrangement is inadequate under an advance funding actuarial cost method; and
- on written request, a non-contributing member may receive any of the information provided to active members of the system.

Written investment policy

The governing body of a public retirement system shall file a copy of the written investment policy with the PRB not later than the 90th day after the date the policy is adopted and file a copy of each change to the policy with the PRB not later than the 90th day after the change is adopted. (Sec.802.202)

Conclusion

Given its limited authority, the Pension Review Board acted appropriately to address the situations in Dallas and El Paso. In authorizing the PRB, legislators deliberately confined its authority to providing technical assistance. The PRB was created, in part, to stave off federal involvement in local funds, and to keep the responsibility for local funds in local hands.

Is it necessary for the Legislature to revisit the role of the Pension Review Board, and to consider increasing its authority? Currently, the vast majority of funds are compliant with state law and are financially sound. For those that are not, the activities of the PRB have drawn attention to the problem and have prompted action. Admittedly, the current structure does not offer expedient solutions. Nevertheless, the committee does not feel that it is necessary to increase the authority of the PRB at this point. It is important for the Legislature to continue to monitor the soundness of local funds, and if additional problems surface, or if existing problems fail to be resolved, then this question should be revisited.

Recommendations

1. **The Pension Review Board should continue to work with local governments and pension funds to resolve any underfunding issues that are identified.**

   The PRB was formed to prevent federal intrusion into local pension plans and to preserve local control. With the creation of the PRB, the Legislature protected the autonomy of local entities over their retirement systems, and provided them with the tools and technical assistance to meet their obligations. Therefore, it is the responsibility of the local entities to ultimately ensure that their systems are adequately funded and to address any deficiencies. The vast majority of local pension funds meet this obligation.

   The current role of the PRB, as defined in state statute, is not to police public pension funds, but to provide training and technical assistance. That is the role the PRB has taken in both the Dallas and El Paso case studies. What is evident from the case studies in Dallas and in El Paso is that the responsibility for the delay in implementing a solution rests at the local level. The PRB promptly identified the problems and offered technical assistance to resolve them. After several years of dispute over the existence of a problem, the Dallas situation has been addressed. The El Paso situation has been on-going for eight years, and although steps are being taken to resolve the issue, the problems may not be settled in the immediate future.

   The case studies also illustrate that the checks and balances that have been established are effective. The State respects the autonomy of the local entities to administer their retirement plans, but also recognizes that the responsibility for developing and implementing solutions rests on the local entities. A solution is not imposed by the State.

   By design, the Pension Review Board lacks the authority to force local governments and pension funds to resolve underfunding issues, and it does not have any authority to force

mediation of any disputes that arise. It does, however, have a powerful tool at its disposal. The PRB can call attention to the problem, and utilize the power of public opinion to force the acknowledgment of a problem and eventually, a solution. The Dallas case study illustrates the effectiveness of this tool.

At this point, the committee believes that local governments should continue to have the responsibility for ensuring that their funds are actuarially sound and the Pension Review Board should continue to act as a watchdog.

2. Encourage Pension Review Board to continue to use its current authority to enforce compliance with state law.

State law requires these public pension systems to file annual reports with the PRB by a specified deadline. These reports allow PRB staff to review actuarial assumptions and to assure that the plans are fully funded. The majority of pension systems comply with the requirement. However, some remain noncompliant. As of January 15, 2000, 24 public pension systems with assets in excess of $50,000 were noncompliant.[12] There is concern that plans that refuse to file their reports, may have funding problems, but without the report, the PRB is unable to identify any problems.

For those that remain uncooperative, the PRB should explore use of its subpoena power and the writ of mandamus to enforce compliance. The PRB lacks any other enforcement authority, such as the ability to levy fines for noncompliance, but the Committee believes that current powers should be fully utilized before any expansion of authority is considered.

3. The Legislature should continue to monitor the effectiveness of the current system to address problems with local retirement systems.

The ability of local retirement systems to deliver the benefits they promise is an issue of statewide importance. The Legislature should continue to monitor this situation to ensure that when problems occur, local solutions are enacted.

DEFINED CONTRIBUTION / DEFINED BENEFIT

DEFINED CONTRIBUTION / DEFINED BENEFIT

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with evaluating the pros and cons of defined contribution plans that do not guarantee members any specific level of benefits upon retirement. The charge stipulates that plans adopted in other jurisdictions should be considered and compared with Texas' state plans in regard to their ability to provide security to retirees, cost, and fairness to diverse employee groups.

A History of Public Pension Plans

Pension plans provide income to employees upon retirement. These benefits are offered as part of an overall compensation package designed to attract and retain qualified employees. Across the nation, all state government employees and nearly all local government employees are provided pension benefits. The first public pension plan started in New York City to cover the police force.[13] In 1911, Massachusetts became the first state to develop a retirement program for its state employees, and by 1947, every state provided retirement benefits.[14]

According to the Department of Labor, over 90 percent of public-sector employees are currently covered by pension plans.[15] The public employees covered under these plans are a diverse group with varied careers, income levels, and retirement needs. In designing a plan to best meet the needs of the individual and the state or local government, several objectives must be considered. These objectives provide a general framework for designing a plan. The pension plan should:

- Attract and retain a high-quality work force;
- Allow employees to depart from the work force financially secure and maintain the value of benefits throughout retirement;
- Provide benefits that are fiscally responsible and financially supportable;
- Fund benefits on an actuarially sound basis; and
- Invest assets prudently for the exclusive benefit of plan participants.[16]

Prior to the 1970s, public retirement systems were frequently financed on a pay-as-you-go basis. Since that time, a considerable focus has been placed on pre-funding benefits, and as a result, the vast majority of plans are actuarially sound.[17]

In addition to Social Security benefits, employers may provide retirement benefits under two basic structures: defined benefit plans and defined contribution plans. The purpose of the pension plan is a question that is critical in determining the best plan design. This question is central to the debate between the superiority of a defined benefit plan structure or a defined contribution plan structure.

Defined Benefit (DB) Plan

DB plans have been the standard form of retirement plans in the public sector since the 1940s.[18] In a defined benefit plan, customarily, both the employee and the employer will contribute to the plan. Benefit levels, however, are independent of any given individual's contribution. The level of benefits an employee will receive at retirement is derived from a formula. This formula is based on years of

service, salary, and a multiplier factor. The basic formula typically looks like this:

(years of service) x (final average salary) x (multiplier)

All states make use of this basic formula, but the definition of final average salary and the multiplier factor differs from plan to plan.

In DB plans, benefits are the contractual obligation of the employer, and as such, employers bear the risks of investment performance. In addition to the retirement benefits, DB plans frequently include disability benefits, early retirement incentives, and post-retirement cost-of-living adjustments.

Defined benefit plans require employees to "vest" before they are entitled to a benefit. Vesting occurs when an employee is entitled to receive a present or future pension benefit that is no longer contingent upon additional service to an employer. An employee must be a member of a plan for a set number of years before they are entitled to a benefit. Approximately 33 percent of statewide systems have a vesting requirement of ten years. Fifty percent have a vesting requirement of five years of credited service (including the Teacher Retirement System and the Employees Retirement System). Ten percent have three or four year vesting. The Arizona and Wisconsin consolidated retirement systems are the only two statewide plans to allow immediate vesting of benefits.[19]

Defined Contribution (DC) Plan

As the name suggests, in a defined contribution plan, the amount of contribution is defined, but the benefit amount is uncertain. With a DC plan, the employer contributes a specified percentage of salary into each employee's individual account each year. Employees often contribute, as well. This individual account is credited with contributions and earnings and charged with investment losses and expenses. The benefit amount at retirement is the account balance. Under a DC plan, there is no guarantee of a certain benefit level, and the employee bears all of the investment risk. In addition, DC plans typically require the employee to bear the risk of pre-retirement death and disability.

At retirement, the benefit can be received as a lump sum, as equal payments over a specified number of years or can be used to purchase an annuity for a lifetime benefit.

Hybrid Plans

In addition to the traditional DB and DC plans, several states have developed hybrid plans that contain elements of both DB and DC plans. There are a variety of ways that states have modified DB plans to have some of the advantages of DC plans.

Comparison of Features

With the strong performance of the stock market in recent years, there has been increased interest in the movement from DB plans to DC plans in the public sector. It is important to assess the advantages and disadvantages of each type of plan to determine which best serves the needs of the State.

Risk

While there are many differences between the two plans, one of the primary differences is who bears the risk. Under a DB plan, benefit levels are set, but contribution levels needed to fund those benefits are not predictable over the long-term. Based on periodic evaluations, contribution rates are set at a level that is adequate to pay the promised benefits. Ultimately, in a DB plan, it is the employer who bears the risk. On the other hand, with a DC plan, the contribution levels are predictable, but the

benefit levels are not guaranteed. The individual employee makes the investment decisions and bears the risk.

Under a DB plan, benefits are funded over a period of time, usually between ten and thirty years. As a result, it is possible for a DB plan to have assets less than the present value of the benefits promised. In this situation, contribution levels must be increased. Therefore, it is the employer who bears the risk of investment performance.

The chart below summarizes who bears the risk from a variety of factors in the DB and DC plans.

FEATURES OF DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

	DEFINED BENEFIT	DEFINED CONTRIBUTION
Inflation	Automatic or ad hoc adjustments can be provided to offset the impact of inflation on retirement income. However, without automatic adjustments, there is no guarantee that benefits will be protected from impact of inflation.	In a DC plan, the retiree generally bears the inflation risk. An employee's protection against inflation depends on investment earnings.
Employee Salary Changes	Salary increases affect both past and future benefits.	Salary changes affect only future contributions.
Investment Results	Investment performance affects funding, not benefits, directly. However, strong investment performance can lead to enhanced benefits in a DB plan.	The performance of investments will determine the employees retirement benefit.
Employee Risk	Future benefits are determined by a formula, and benefit levels are guaranteed.	No guarantee as to the level of benefits that will ultimately accrue.
Employer Risk	Regardless of investment performance, employer pays a set retirement amount. In a DB plan, employers bear the risk.	No risk for the employer, the employee bears the investment risk.

	DEFINED BENEFIT	DEFINED CONTRIBUTION
Longevity	Benefit levels are guaranteed to be provided throughout a retiree's lifetime. Retirees are often given the option of also providing survivor benefits.	Benefits are limited to the account balance. Retirees must try to plan for enough benefits for an uncertain period of time. Whatever remains unspent at their death can be passed on to survivors.

Administrative Issues

There is much debate over which costs more, a DB plan or a DC plan. In the private sector, where cumbersome regulations burden DB plans, there is little doubt that the DB plan is more expensive to administer. From 1981 to 1996, the Hay Group tracked the relative administrative costs of DB and DC plans. In 1981, a very large DB plan cost $245,000 a year to administer compared to a very large DC plan which cost $270,000 a year to administer. By 1996, the DB cost had risen to $717,00, and the DC costs were $517,000.[20] The difference in cost trends in the private sector is due in part to Congress' effort to simplify DC plans for the private sector.

In the public sector, the major difference is who usually pays the costs in a DB or a DC plan. For the most part, the administrative costs of a DB plan are paid for by the performance of the fund. In a DC plan, there are administrative costs relating to education of membership and maintenance of individual accounts. Furthermore, transaction fees are normally charged to the individual. A Pension Welfare and Benefits Administrations report found that participants in 401(k) plans typically bear investment management fees that range from 75 to 90 percent of the total administrative fees and expenses that are borne by a plan.[21]

Portability

Proponents of DC plans claim that the nature of the workforce has changed. Employees no longer work for one employer throughout their career. The average employee will have at least seven different jobs over his or her lifetime. DC plans are fully portable which means that benefits from qualified public sector plans can be rolled into another qualified plan. As a result, some argue that DC plans are more suited for today's workforce.

Furthermore, proponents of DC plans assert that employees continue to earn benefits by earning investment income when they change jobs or leave employment altogether. Typically in a DB plan, if an employee terminates employment, they can withdraw their contribution with a modest interest rate, but they receive no employer contribution. If they leave their money in the plan, their retirement benefits are essentially frozen.[22]

Proponents of DB plans claim that although DB benefits are not fully portable, there have been many improvements in the portability features of DB plans. Most DB plans have a service purchase provision. For example, in Texas, the Teacher Retirement System allows public school employees to purchase service time in out-of-state public schools. When plans do allow the purchase of service

credit, it is limited to selected types of service. This limitation allows employees the advantages of portability, but limits the costs to the plan. Generally, the purchase of service credit is limited to service with other public sector employers, such as the military.

In addition, a common means of transferring service among public sector employees is through reciprocity agreements. Typically, these agreements are among state and local government employers, within the same state, who agree to transfer service, funds, or both, for individuals that have worked for two or more employers participating in the agreement. This allows for portability among public employers.

Furthermore, W. Michael Carter, an actuary with Watson Wyatt, notes that the perception that employees in general are more mobile today than they have been in the past is an inaccurate assumption. According to recent studies conducted by Watson Wyatt, there has been very little change in average job tenure over the last 40 years. Their studies also find that termination rates have actually declined across all age and service groupings over the last 10 - 15 years.[23]

Benefit Adequacy

Simply stated, DC plan advocates note that in a DC plan, there is no limit to the benefits an employee can accrue. Proponents of DB plans reply that there is also no guaranteed minimum benefit level under a DC plan.

Furthermore, DB plan proponents argue that the portability of DC plans does not necessarily guarantee retirement savings. DC plans have a pre-retirement distribution option which allows employees to cash in the plan, or borrow against it. E. Friend, president and chief executive officer of EFI Actuaries, referred to this option as "leakage from the house of retirement."[24] United States Congressman Earl Pomeroy warns that this "leakage" may be leading to a national crisis because DC plans may provide inadequate income to retirees in the future. The issue of inadequate income for retirees is particularly relevant in the public sector. Inadequate retirement benefits will increase the demand for public assistance programs. As a result, ultimately the taxpayer will bear the liability of ensuring adequate retirement benefits in either a DB or DC plan.

Despite repeated warnings not to cash out retirement money unless it is absolutely necessary, a study by Hewitt Associates reveals that the majority of 401(k) participants, regardless of age, are choosing to take lump-sum payments when changing jobs instead of rolling the money into Individual Retirement Accounts or their new employer's retirement plan. The company's study reveals that for workers ages 20 - 59, 68 percent opt for cash payments when changing jobs. Only 26 percent roll their balances into IRAs and only 6 percent move their money into their new employers' plans.[25]

Furthermore, DC plans generally do not provide subsidized benefits, including disability, survivor benefits, etc. The average employee would need to take about 1 percent of pay (younger employees less and older employees more) to purchase death and disability benefits that are provided by a DB plan but not a DC plan.[26]

Fund Performance

According to a recent study in the *Financial Analysts Journal*, three fund attributes determine the performance of the fund: fund size, proportion of assets passively managed, and the quality of the fund's organizational design. An analysis of this study performed by Cost Effectiveness Measurement Inc.

determined that bigger is better in pension funds for two reasons: (1) economies of scale and lower unit operating costs; and (2) the ability to support a full-time professional management team dedicated to producing long-term results.[27] These factors would seem to indicate that DB plans would tend to yield higher returns than DC plans. In fact, aggregate returns are lower in DC plans because older DC participants are less able to tolerate risk.[28]

DC plan proponents argue that in public pensions, investment decisions are often influenced by factors other than economics. For example, some investment decisions are made based on opposition to social issues -- this is referred to as social investing. Examples of social investing include the decision of some funds to divest investments from South Africa, or the more recent example of funds divesting assets from tobacco companies. In addition, some boards utilize "economically targeted investments" (ETIs). ETIs are usually selected in an attempt to bolster the local economy and are not selected based on investment returns. In fact, a 1983 study found that ETIs can cause a 2 percent reduction in returns.[29] One study estimates that non-economic investing cost public pension funds over $28 billion in losses between 1985 - 1989.[30]

Individual Control

In a DC plan, retirement funds for each worker are under his or her direct ownership and control. Proponents of DC plans claim that this allows workers to select investments that best meet their retirement needs instead of forcing them to participate in a "one-size fits all" plan. Furthermore, this direct control over their investments allows employees to reap the benefits of strong investment performance.

DB plan proponents note that under a DC plan, individual control is limited to those options offered by the plan sponsor. In addition, they argue that the shifting of investment risk from the employer to the employee is a significant, but often overlooked issue. Recent investment experience has been favorable, but that may not continue. Furthermore, in a DB plan, the employer is able to take a long-term view regarding investment performance, but an individual may not have that flexibility. In fact, many individuals are more conservative when they have control over their investments, which results in a lower rate of return.[31] Numerous surveys indicate that individual, non-professional investors will under-perform the market by as much as 2 percent (200 basis points).[32]

Simplicity

Benefits accrued under a DC plan are easy to understand. The simplicity of the DC benefit structure is often cited as a factor for its superiority to a DB plan. DB plans use complex formulas to determine benefits. It is impossible to determine the total benefit which will be received under a DB plan because the formula is based on factors that cannot be predicted, such as longevity.

Costs are also easier to predict under a DC plan. Employer's contributions are limited to a fixed percentage of salary under a DC plan. In a DB plan, assumptions are made about retirement patterns, market performance, etc., to determine the contribution amount. Ultimately, however, the employer must guarantee a certain benefit level.

Recruitment / Retention

DC plan advocates claim that the flexibility and portability of a DC plan makes working for the government more attractive to younger professional workers who do not expect to work in the public

sector for their entire career.

DB plan proponents counter this claim by noting that younger employees tend to worry less about long-term security and retirement, and as a result, retirement benefits may not be an effective recruiting tool. In addition, they note that the DB plan design encourages retention of employees. Furthermore, they note that the DB plan design is attractive to mid-career employees. Numerous studies have shown that mid-career and older workers (those over age 45) understand the value of DB plans, and in many cases, it is these experienced employees that the public employer will be trying to recruit.[33]

Gender Equity

Proponents of DC plans argue that some of the greatest beneficiaries of defined contribution plans are women. They note that women benefit from shorter vesting schedules, the absence of benefit formulae, and the portability of DC retirement benefits.[34] In general, women are more likely to have interrupted work histories because of family responsibilities. As a result, DC plan advocates claim that women who take time off to raise a family are penalized because defined benefits are frozen when they leave the system. On the other hand, under a DC plan, a woman who takes time off to raise a family continues to accrue investment returns on her plan. Furthermore, they note that women are often the "victims" of DB plan formulas because these formulas are calculated using their final salary (usually an average of the three highest years salary). Since women's salaries are lower, on average, than men's salaries, their benefits are also lower.

In contrast, many people believe that a DB plan can provide women with higher benefits. Women who work part-time while raising a family actually accrue greater benefits under a DB plan, proponents of this retirement structure note. While calculating retirement benefits under the formula, years of service does not differentiate between part-time and full-time service. Therefore, women may have more flexibility and greater retirement benefits under a DB plan. In addition, proponents of the DB plan structure note that while women's salaries tend to be lower than men's salaries, either retirement structure will then result in lower benefits. If women have lower salaries than men under a DC plan structure, their contributions will be less, and as a result, their overall retirement savings will be lower.

<u>Retirement Plans in Texas</u>

Employees Retirement System

State employees in Texas participate in the Employees Retirement System (ERS). ERS currently manages a $19 billion trust fund. The ERS fund is the 29th largest public pension fund and the 49th largest pension fund in the nation. There are 154,183 active members and 43,860 retirees participating in ERS. The fund has no unfunded liabilities.

ERS administers a separate fund and retirement plan for law enforcement officers and custodial officers for the State's prisons and jails. Two separate plans cover the state judges (one plan is being phased out and replaced by another). The largest fund covers all other state employees. The details of that plan are outlined below.

The employee contributes six percent of wages which goes into an individual account and earns five percent simple interest. The State contributes six percent of the salary of each state employee to help with the overall financing of retirement benefits. These combined contributions are invested, and the contributions plus the investment returns fund retirement, death and disability benefits.

State employees are eligible to retire at the age of 60 with 5 years of state service, or when their years of service combined with their age equals 80 -- often referred to as the “Rule of 80.” For example, an individual would be eligible to retire at the age of 50 with 30 years of credited service.

Monthly retirement benefits are based on the formula:

2.25% x years of service x final average salary

The final average salary is the average of the thirty-six highest monthly salaries.

EXAMPLE: For a retiree who is 50 years and 8 months old, with 29 years and 4 months of service credit, and a final average salary of $2,800

Calculation of the standard annuity

Final average salary		$2800.00
Percentage value of creditable service (Based on 29 years and 4 months of credit)	x	66%

At retirement, employees may select the standard annuity described above, or they may select from one of the five survivor options. If one of the survivor options is selected, the retirement benefit is actuarially reduced accordingly. In addition, employees have the option of selecting a Partial Lump Sum Option which allows new retirees to request from one to 36 months of their standard annuity as a lump sum payment at retirement. If this option is selected, their monthly annuity payments are reduced so that there is no actuarial impact.

In addition to retirement benefits, employees receive disability benefits for an on-the-job injury with no age or service requirements. Other disability benefits are payable only to employees with at least ten years of state service. Disability benefits are calculated by multiplying 2.25 percent times the years of service with the actual salary at time of the disability. A minimum benefit of 35 percent of that salary is provided.

Employees who separate from state service prior to obtaining retirement eligibility can leave their money with ERS as a non-contributing member. They can begin to draw an annuity if they have at least five years of service and reach the age of 60, or when their age plus years of service equals 80. They can also withdraw their contribution. If the contribution is withdrawn, the ERS membership and service credit is canceled. If an individual returns to state service after withdrawing his or her contribution, they do have the option to buy back service credit.

Employees can also participate in a deferred compensation (457 and 401(k)) plan. Participation in these plans is optional and there is no employer contribution. Over 62,000 state employees participate in either the 457 or 401(k) plan.

Teacher Retirement System

The Teacher Retirement System was created by constitutional amendment in 1937 to provide

retirement benefits for public education employees, including employees of institutions of higher education. TRS currently has 919,000 active member annuitants and manages an $80 billion trust fund. It is the eighth largest defined benefit plan in the nation. The plan's benefit liabilities are actuarially fully funded.[35]

The employee contributes 6.4 percent of wages which goes into an individual account and earns five percent simple interest. The State contributes six percent of the salary of each state employee to help with the overall financing of retirement benefits. The State's contribution goes into a separate account. These combined contributions are invested, and the contributions plus the investment returns fund retirement, death and disability benefits.

TRS participants are eligible to retire at the age of 65 with 5 years of state service, or when their years of service combined with their age equals 80 -- often referred to as the "Rule of 80." TRS participants can select early retirement at age 55 with 5 years of service with benefits actuarially reduced.

Monthly retirement benefits are based on the formula:

EXAMPLE: For a retiree who is 55 years old, with 30 years of service credit, and a final average salary of $36,000

The member's standard annuity would be calculated as follows:

Final average salary	$36000.00
Percentage value of creditable service (Based on 30 years of credit)	x 66%
Standard annual annuity =	$23,760.00

2.2% x years of service x final average salary

The final average salary is the average of the highest three annual salaries.

TRS retirees can choose various options for survivor benefits with a reduction in their monthly benefit. Furthermore, a $10,000 lump sum payment is available to the survivor of a retiree. A surviving spouse can instead select a $2,500 cash payment plus $200 per month for the remainder of his or her life starting at the age of 65.

TRS members also have two different lump sum payment options to choose from: the Partial Lump Sum Option and the Deferred Retirement Option Program. Both of these programs allow members to take a reduced monthly annuity in exchange for a lump sum payment. These programs allow members to create an estate within the DB structure.

For TRS members who become permanently disabled, TRS provides disability retirement benefits when a worker cannot continue his or her current duties. TRS members with ten years of credited service at the time of their disability receive the same benefits as for retirement, with a minimum monthly

payment of $150. For TRS members with less than ten years of service, the worker will receive $150 per month for the number of months they contributed to the TRS system.

After five years of contributions into the TRS pension plan, an employee is vested. If an employee leaves public school employment and withdraws his or her contribution, then they will receive his or her own contribution plus five percent interest. A TRS member with over five years of service can leave his or her funds in the plan until they reach retirement eligibility and then they can begin to draw benefits. If an employee chooses to withdraw his or her contribution, the TRS membership and service credit is canceled. If an individual returns to employment with a public school after withdrawing his or her contribution, the service credit can be purchased.

There is no statewide optional deferred compensation program for school personnel. However, many school district personnel are offered these optional plans at the local level.

Texas Municipal Retirement System

The Texas Municipal Retirement System (TMRS), established in 1948, provides benefits to the member city employees. Currently, 738 municipalities participate in the plan, and TMRS manages $7.66 billion in assets. TMRS receives no state funding, but is administered in accordance with the Texas Constitution and Texas Government Code, Title 8, Subtitle G. TMRS administers each plan individually; each city is separate, both actuarially and in terms of funding. However, all of TMRS' assets are pooled for investment purposes.

This TMRS plan is a hybrid of a DB and DC plan known as a cash balance plan. Members contribute a certain fixed percentage of pay, which is matched by the city employer. TMRS invests the funds and grants interest to the members' accounts. A guaranteed retirement benefit is calculated from this account, the city's matching funds and other credits. The retirement annuity for the member is the actuarial equivalent of the sum of the member's own monthly contributions plus interest and an equal or greater multiple sum out of the employer's accumulation account plus interest. Under this type of plan, assets are invested by the retirement system, not the individual.

Each city can choose from a variety of plan options. In fact, there are over 2,300 possible combinations of these choices for municipalities. Options include death and disability benefits, CPI increases, DROPs, etc. Basically, the employee of a TMRS city contributes 5 percent, 6 percent or 7 percent of his or her salary to TMRS. The city matches that amount either 1 to 1, 1 ½ to 1, or 2 to 1. TMRS pays interest on the employee's account and the city's matching funds annually.

In most TMRS cities, a member can retire with at least 10 years of service at age 60. Furthermore, most cities elect to allow members to retire at any age if they have 20 or 25 years of service. Typically, vesting occurs when the member has 10 years of service credit. If members leave employment and choose to withdraw their member contributions and interest, they will not receive the city's matching fund.

The retirement benefit is calculated based on:

- total member contributions made, plus earned interest;
- the sums the city has agreed to pay (matching contributions and other credits granted) on the member's retirement;

- the member's remaining life expectancy at retirement;
- the future interest rate on the annuity amount, as set by law; and
- which of the seven TMRS benefit payment plans the member selects.

Texas County and District Retirement System

The Texas County and District Retirement System (TCDRS), is TMRS' counterpart serving counties and districts around the state. TCDRS is composed of 500 individual and separate county and district retirement plans. TCDRS administers the plans on behalf of each county and district. Like TMRS, TCDRS receives no state funds, but is governed by the Texas Constitution and state statute.

Under federal tax laws, TCDRS is considered to be a DB plan, however, like TMRS, the benefit structure is not that of a traditional final average salary defined benefit plan such as ERS or TRS. The TCDRS benefit structure is commonly referred to as a cash balance plan or money purchase arrangement where the amount of a member's individual benefit is determined by the value of the member's personal contributions and interest earnings, as well as the value of the employer financed credits.

The following factors determine the amount of TCDRS member benefit payment amounts:

- Total dollars of retirement credit the member has accumulated at retirement, where retirement credits consist of the amount of the member's personal account balance (the sum of the member's personal contributions and interest earnings) + an amount of employer financed credits that is always at least equal to the sum of the member's personal account balance, but is usually greater, depending on the election of each employer. For example, the average ratio of employer financed credits to the individual's personal account balance is 1.5, meaning that, on average, TCDRS plans provide employer financed credits equal to 150 percent of the individual member's personal account balance. Since individual members generally contribute 7 percent of pay to the plan, the end result is that members are accumulating retirement credits on an annual basis equal to 17 ½ percent of pay and those credits are increased each year by an annual interest allocation (currently 7 percent).
- The anticipated duration of benefit payment (actuarially determined based on the member's age at retirement and other underlying guarantees, e.g., period certain guarantee, survivor beneficiary lifetime guarantee).
- An annuity interest rate assumption of 7 percent (the reserves of retired members are guaranteed a 7 percent annual interest rate throughout the payment period and this guarantee is incorporated in the determination of the member's benefit payment and enhances that payment).
- Benefit payments can be periodically increased through post-retirement cost of living adjustments, if such adjustments are authorized and funded by the sponsoring county or district.[36]

Optional Retirement Program

In Texas, higher education faculty, librarians, and certain administrators and professionals can choose between participating in the TRS retirement system, a DB plan, or the Optional Retirement System

(ORP), a DC plan. Eligible employees have 90 days from their first date of eligibility to make a one-time irrevocable election of ORP in lieu of TRS.

The Legislature established ORP in 1967 to provide a more portable retirement option for higher education employees whose careers routinely involve interstate mobility. Because of the mobility involved in the academic profession, many colleges and universities across the country offer ORP-type plans. The Texas Legislature authorized the creation of the ORP so that Texas could use the ORP as a recruitment tool to attract the highest quality individuals to Texas.

ORP was established by the Legislature as a de-centralized plan. Texas Government Code, Chapter 830, authorizes each governing board to administer its own ORP. As a result, institutions may make arrangements for ORP products to be offered to their employees by any insurance or investment company qualified to do business in the state. Most institutions offer a range of ten to twenty vendors. In total, there are over 100 companies authorized by all higher education institutions. Ten of these companies receive contributions from 75 percent of all participants and 20 companies receive contributions from 90 percent of the participants.

The Texas Higher Education Coordinating Board is charged with ORP responsibilities in three areas: eligibility, uniformity and reporting. The Higher Education Coordinating Board collects and reports data on participation in the ORP, but it does not track individual performance of ORP accounts. Therefore, it is difficult to compare the performance of the ORP to the DB plans in existence in the State. From time to time, the Committee has heard pleas from higher education employees who have requested the opportunity to switch from ORP to TRS after the 90 day period of initial employment has passed. In fact, in 1979, the Legislature authorized a one year window for individuals who had switched from TRS into ORP, to return to the TRS system.

Combining Service Credits

In Texas, service credits may be combined if a member participates in two or more of the following retirement systems: Employees Retirement System, Judicial Retirement System of Texas Plan One and Plan Two, Teacher Retirement System of Texas, Texas Municipal Retirement System, Texas County and District Retirement System, or the City of Austin Retirement System. When your age and combined service credits satisfy the retirement eligibility requirements of any one of the systems, you may receive a retirement benefit. You will receive monthly annuities based upon the annuity criteria of the respective systems. For example, an employee is 60 years of age and has four years service credit with the ERS and four years service credit with another statewide retirement system. Both systems allow members to retire at age 60 with at least five years service credit. Because combined service meets eligibility requirements for both systems, the employee may receive a monthly annuity from ERS based on four years of service and a monthly annuity from the other system based on four years of service.[37]

Experience of Other States

In the private sector, there has been a significant decrease in the number of DB plans over the last ten years and a large increase in the number of DC plans. This increase in popularity of DC plans is often cited by proponents of DC plans in the public sector as evidence that public retirement systems are behind the times. That is not entirely the case when you look beyond the numbers. Virtually all of the decrease in the number of DB plans has occurred among small and medium size employers (employers

with less than 1,000 employees). Large employers, for the most part, have continued their DB plans and added DC plans. The decline in DB plans among small employers can be explained by the expense of complying with the complex and burdensome regulations of the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation. The public sector is exempt from most of these regulations.

As a result, the trends in the public sector are different. Currently, the majority of the retirement plans in the public sector are defined benefit plans. Among the approximately 100 large statewide plans, three are DC plans: Nebraska Public Employees Retirement System, the West Virginia Teachers Retirement System, and the Michigan State Employees Defined Contribution Plan[38]. As of 1998, 94 percent of all public sector assets were invested in DB plans.[39] Despite the preponderance of DB plans, many public sector plans also have a DC option. A March 1999 report from the General Accounting Office (GAO) notes that all states have a defined contribution component, but at that time, only nine states contributed to the plan. Thirty-five states had retirement programs that included a DB component, a DC component with no employer contribution, and Social Security .[40]

The GAO report also notes that all states have in some way changed the design of their retirement programs since their establishment. Many of the changes have been in response to changes in federal regulations. Other changes have been enacted to enhance benefits for employees.

As of March 1999, of the 48 state retirement programs with a DB component, officials representing 21 states indicated that they had considered dropping their DB component in favor of a DC plan. Reducing government costs, enhancing portability, and/or lobbying by special interest groups were among the reasons cited for considering such a change. The most common reasons cited for not making a change to a DC plan were: studies indicated there was no need to change; further study was needed; state's labor unions opposed the change; and/or there was a lack of interest or support.[41]

While few legislatures have abandoned DB plans in favor of DC plans, many legislatures have increased employee options through reductions in vesting requirements, improved benefits for employees who leave before vesting or reaching retirement age, and employer contributions to DC plans.[42] In addition, nine systems allow a limited class of state employees to select between a DB and DC plan. This selection is usually limited to agency heads, elected officials, legislative staff or others who typically have a short tenure.

Nebraska

Nebraska presents an interesting case study in the DB/DC debate. While other states have recently adopted DC plans, Nebraska adopted one over thirty years ago. In the mid-sixties, the Nebraska Legislature authorized two statewide defined contribution plans: one for state government employees and another for county government employees. Prior to the creation of these plans, there was no employer-sponsored retirement plan for those employees. In previous decades, Nebraska had created DB plans for school employees, state judges and state patrol employees. In choosing a DC plan over a DB plan, the historical record reflects that the Legislature was concerned about unfunded liabilities in the existing DB plans.

Initially, investment options available were limited to a simple interest insurance product marketed through a major insurance company and an annuity product. In the 1980s, Nebraska expanded its investment options, increased the state/county contributions and continued the annuity program. Today

it offers members eleven investment options, daily valuation of accounts, Internet access to account information, and a comprehensive education program. Upon retirement or termination, members have the option to take an annuity, a systematic withdrawal of contributions, or a lump sum of the entire account.

In a letter to the Pensions and Investments Committee, Anna Sullivan, Director of the Nebraska Public Employees Retirement System, identifies some of the advantages and disadvantages of the DC plan based on Nebraska's experiences.

Advantages

- portability for all employees;
- greater benefits for short-term employees;
- no unfunded liabilities for employer;
- investment risk borne by members, not employer; and
- multiple options at retirement.

Disadvantages

- communication and educational challenges for a diverse workforce, especially in the area of investment and retirement decisions;
- smaller benefits at retirement due to conservative investment selection or risk of retiring during a market correction;
- investment risk borne solely by members;
- high cost of bundled investment products, which lowers overall investment return for members;
- heavy marketing to members upon retirement by financial firms wanting the member to roll a lump sum to them for their investment; and
- lack of cost-of-living adjustment options after retirement.

Sullivan sums up Nebraska's experience by stating, "Our experience with the defined contribution plans has been mixed. We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."

She notes that the administrative costs of a DC plan are high. In Nebraska, they spend more in investment management fees, record-keeping fees, educational programs and material with the defined contribution plans than with the defined benefit plans. In 1999, Nebraska's plan expenses for their defined contribution plans were approximately 30 basis points (BP) versus 15 BP for their defined benefit plans.

Nebraska commissioned a study to review the benefit adequacy of the Nebraska Retirement System. In 1994, Buck Consultants completed a study which measured the purchasing power of estimated lifetime income as a percentage of final salary. They looked exclusively at employees who worked a thirty year career with the state, and found that all of these employees would have a higher percentage of purchasing power based on their final salary under their DB plan.[43] In addition, a December 1998

study showed that pension plan participants fared better than their DC counterparts in Nebraska. The study found that ten years after retirement, a retiree with 30 years of service who had an average annual salary of $30,000 receives about $11,230 each year from a DC plan. A DB plan participant with similar pay and service credit receives $16,797 each year.[44]

Minnesota

Another state which had a mixed experience with a defined contribution plan is Minnesota. Between 1969 and 1972, public school employees in Minnesota were given the option of a DC plan instead of the DB plan. Approximately 15,000 employees selected the DC option. For many of these individuals, the financial benefit was not as great as expected. In 1978, dissatisfied DC plan participants complained to the Legislature, and as a result, they were converted back to the DB plan in a two step process. This experiment cost the state about $120 million.[45]

Florida

In 2000, the Florida Legislature passed legislation to restructure the Florida Retirement System as a plan with two basic programs - a defined benefit plan and defined contribution plan. The FRS has 600,000 members and $101 billion in assets, and is the fourth largest public pension plan in the country. Unlike other States that have passed legislation creating a DC retirement plan, Florida gives existing employees the option of moving their assets from the DB plan to the DC plan. The Florida Legislature established an employer-funded optional DC plan, the "Public Employee Optional Retirement Program," and restructured the existing DB plan to be optional.

Prior to the adoption of the legislation, the Florida Legislature commissioned a study of employees to measure their overall satisfaction with current retirement benefits and to determine employee interest in alternatives to the defined benefit plan. The survey found that when presented with two plan descriptions (DB and DC), respondents were split on their preference. However, the importance rating of desired features in a plan indicated a tilt toward a DB plan preference. Most respondents were interested in having a choice between two retirement plans. The most important features of a retirement plan as identified by respondents was a monthly guaranteed lifetime benefit and portability of benefits. Respondents also indicated that the DB plan benefits motivated most respondents to continue working for the state.[46]

Under the plan adopted by the Florida Legislature, existing employees will be given 90 days to transfer to a DC plan. New employees will have 180 days to decide between the DB and DC options. After the regular enrollment period, each employee will have one chance to move from one plan to another. Some questioned the feasibility of allowing employees the opportunity to move from one plan to another. The director of the Florida Division of Retirement noted that this provision could create a strain on taxpayers if people who did not do well with their DC investments returned to the DB plan just before their retirement.[47]

An FRS member who elects to transfer to the defined contribution program could either keep the service credit earned under the DB program and remain eligible for a future lifetime benefit, or move the value of his or her service credit to the DC account.

Participants in the DC plan will vest in employer contributions paid into his/her account after one year of creditable service. Benefits will accrue in individual, participant directed accounts. The bill expresses

an intent to establish disability coverage for employees who select the DC plan.

Employees do not have to contribute in either the DB or DC plan. In the DC plan, the contribution rate is equal to the contribution rate for the DB plan minus the cost of administration and disability coverage.

Participants in the DC plan vest in one year. If a current employee already has over one year of service credit and selects the DC plan, he or she will be immediately vested. In addition, the Florida Legislature reduced the vesting period for participants in the DB plan from ten years to six.

Florida expects to provide employees who select the DC option with between five and eight mutual funds from which to choose investments. The State Board of Administration, the entity which manages the current DB plan, will select the investment options and decide whether to bundle services. The legislation also allows for an unbundled approach or more than one bundled or semi-bundled provider. It also allows for investment education for plan participants.

One unanswered question that remains regarding Florida's new legislation is what will happen if employees opt out of the DB plan, leaving no new money flowing into the DB plan to pay for current obligations. If the influx of new members into the DB plan is substantially reduced, and there is no reduction in the benefit payout of the DB plan, a significant imbalance between the contribution inflow and the benefit outflow will result.[48] In this scenario, will taxpayers get stuck with the massive transition liability?[49]

Montana

In 1999, Montana authorized an optional defined contribution plan for Montana Public Employees Retirement Systems (PERS) members to be effective by July 1, 2002. Membership in PERS is comprised of approximately 28,000 state, university, county, municipal and school district employees other than teachers. When the DC plan was authorized, the existing DB plan had future benefit obligations which exceeded assets on hand by about $200 million.[50]

All current and future Montana PERS members will be eligible to select the DC plan or the existing DB plan. The DB plan will continue to operate and be open to new enrollees. Current members will have one year after the effective date to select the DC plan. New employees will be enrolled in the DB plan by default, and they will have one year from their date of employment to opt for the DC plan.

A choice to remain in the DB plan or to transfer to the DC plan will be a one-time, irrevocable choice for the duration of the employment cycle. An individual who withdrew from either plan and was rehired into covered employment after a break in service of less than 24 months would have to rejoin the plan from which the member withdrew. A person with a break in service of more than 24 months will have the same plan choice as a newly hired employee.

The DC contribution rate will be 6.9 percent from employees and 4.53 percent from employers. (Current DB contributions are 6.9 percent from employees and employers). To offset the unfunded actuarial liability of the DB plan, employers who contribute to the DC plan will also pay into the DB at a rate of 2.37 percent of covered compensation. This amount may be adjusted up or down as required by the DB plan's performance.[51]

A key component of Montana's plan is the "plan choice rate." This ensures the DB plan's actuarial soundness and also protects the DC plan's funding from being tapped to pay the DB plan's future unfunded liabilities or increases in the normal costs of benefits in the DB plan not caused by members

opting out of the DB plan and into the DC plan. The plan choice rate is an actuarially determined and adjustable percentage of payroll that the employer continues to pay to the DB plan until past obligations are paid and normal cost changes stabilize.[52]

For existing members who transfer from the DB plan to the DC plan, the amount of funds transferred will include past contributions; the employer contribution, less the amount required to offset the unfunded actuarial liability; and the interest compounded at 8 percent.

DC plan participants will be vested immediately in their own contributions, and over a five-year period, they gradually vest in the employer contributions, as well.

Current trustees of Montana PERS will also act as trustees for the DC plan. They are required to contract out administrative, educational and investment services. In addition, they are required to offer at least eight investment choices to DC members.

The Montana Legislature has not resolved the issue of providing health and disability insurance for DC plan members. Legislators are considering severing disability from pension plans altogether. In addition, they are currently studying the health insurance issue.[53]

Michigan

A DC plan for state workers and public school employees was proposed by Michigan Governor John Engler and passed by the Michigan Legislature in 1996. The plan mandated that all new state employees and public school employees hired after a specified date would be enrolled in a newly created DC plan. (The plan for public school employees was repealed prior to enactment because of opposition from school employees). Existing employees were given the option of remaining in the DB plan or transferring membership to the DC plan. For those members who transfer from the DB plan, the actuarial present value of the member's accumulated benefit obligation plus accumulated contributions are transferred.

For participants in the DC plan, the state contributes 4 percent of the employee's salary into his or her DC account. The individual can contribute up to 3 percent of his or her salary and receive a state match. The state match is in addition to the 4 percent contribution. Individuals can contribute larger amounts, but receive no additional state match.

DC plan participants immediately vest in their personal contributions, and gradually vest in employer contributions. They are fully vested in employer contributions after four years of credited service. They become vested in health insurance after 10 years of credited service. Members of the DC plan direct their investments into categories of investment funds offered by the state treasurer, and they are responsible for all administrative costs.

Colorado

In 1995, the Colorado Public Employees Retirement Association (PERA) recommended changes to the General Assembly to improve the portability and flexibility of its retirement system. Changes were advocated, in part, because in Colorado, state employees are not covered by Social Security. As a result, the guaranteed lifetime benefit provided by a DB plan is important, but non-vested employees and employees who leave state employment early in their career also need retirement security.

The changes adopted by the General Assembly in 1995 maintained the DB structure, but added

increased portability for shorter term state employees. For example, changes included: the addition of an employer match to employee contributions withdrawn from PERA; a higher interest rate on member accounts than before; and the option of a lifetime benefit for nonvested members who leave PERA-covered employment but who leave their funds with the system. These revisions applied to all active and inactive members of PERA. The benefit improvements were applied retroactively.

In Colorado, employees contribute 8 percent of their monthly salary. The State of Colorado contributes 11.4 percent, 10.0 percent and 15.0 percent for state and school, municipal and judicial employees respectively. Of those amounts, 1.1 percent is used to fund the health care trust. Vesting in PERA occurs with five years of service. Under the new Colorado law, individuals who withdraw their contributions before vesting will receive interest calculated at 80 percent of the PERA actuarial investment assumption rate (currently a yield of 6.8 percent) plus a 25 percent matching employer contribution. Interest is calculated from the date of the contribution. If a member who is not vested leaves his or her contribution with PERA until they are 65, the match rate increases to 50 percent and the member may choose a lifetime benefit instead of a refund. This lifetime benefit is a money-purchase plan based on the member's contributions, interest and the 50 percent match. Cost of living adjustments and a health care subsidy are included with the lifetime benefit.[54]

Vested members also receive enhanced benefit options under the new Colorado plan. Member's benefits are calculated in two different ways: as a money-purchase benefit and according to the defined benefit formula. The member receives the greater of the two benefits. At retirement, vested members who have left their contribution in PERA may choose to receive a lump-sum refund including the 50 percent employer match instead of the lifetime benefit. In addition, the plan offers death and disability benefits.

Deferred Compensation Plan Matches

Several states have recently passed legislation to match employee contributions in voluntary deferred compensation plans. In 1998, Oklahoma and Tennessee adopted legislation to match employee contributions in order to stimulate participation in the voluntary deferred compensation programs. In Oklahoma, participation has jumped from 20 percent of eligible employees to 78 percent. In Tennessee, participation has increased from 20 percent of eligible employees to 40 percent.[55] In 1999, Arizona, Colorado, Indiana, Maryland, South Carolina, and Virginia authorized some level of employer match to supplemental plans.[56]

Targeted Defined Contribution Plans

A few states have created defined contribution plans for a narrow segment of the workforce, such as elected public officials, legislative staff, or agency heads. For example, in 1999, Arizona adopted an optional DC plan for exempt state employees and elected state officials who are subject to term limits. Louisiana created an optional DC plan for a small group of unclassified state employees which includes statewide elected officials and political appointees. Only about 100 positions are eligible for this DC plan. Participants and the state in the Louisiana DC plan will contribute the same amounts as they would have in the state DB plan.

Analysis of the Problem

The debate over which retirement structure is superior for public employees has become a politically

charged issue. Nevertheless, the issue before the Committee is which plan better meets the needs of the State and the employee?

A traditional DB plan definitely rewards employees with longer service. It provides the greatest value to the employee who stays to retirement. As a result, the average age and average service credit in the typical public pension plan is consistently higher than in the typical private sector plan. Conversely, the DC plan typically favors the shorter service employee. The employee who works for a few years and leaves public employment will leave with a greater benefit under the DC structure.

The Committee's charge specifically states that Texas' current retirement programs should be compared to those in other jurisdictions and judged on three criteria: their ability to provide security to retirees, cost and fairness to diverse employee groups.

In terms of security, the DB benefit program provides retirees with the most stable retirement benefits. There is a valid argument that DB plans do little to help short-term workers save for retirement. However, statistics show that younger, short-term workers tend to cash in their 401(k) plans instead of saving for retirement. For the refunds of TRS member accounts issued in FY1999 and FY2000, only 18 percent to 19 percent of those withdrawing their retirement funds rolled them into another retirement vehicle. Therefore, a DC plan may not actually help younger workers save for retirement. Furthermore, the majority of states that have adopted DC plans have done so recently, so it is difficult to judge the impact on retirees, particularly because we are currently experiencing strong market performance. Nebraska, the one state that has had a DC plan in place for over 30 years admits that its results have been mixed and that retirees in its DB plan appear to be better off.

The issue of cost is more difficult to determine. Several states that have adopted DC plans did so because their DB plans were not fully funded or because they were concerned about uncertain funding obligations. Short-term costs for the State appear to be about the same with either plan design. In a DC plan, the administrative costs shift from investment costs to education costs. Recently, states such as Florida have offered employees the option of selecting between a DB and a DC plan. The long-term implications of this are unknown. When you allow employees the option to choose between two plans, they will select the plan that best meets their needs. While this ability to choose is beneficial to the employee, it increases the total cost for the entire system. For example, a young employee who does not plan to make a career with the state will select a DC plan. A mid-career employee who plans to work for fifteen to twenty additional years will select a DB plan. This adverse selection can drive up normal costs for the DB plan. In 1990, the State of Texas commissioned a study regarding the issue of DB vs. DC plans. At that time, normal costs for the ERS were around 11.861 percent. The consultant who completed the study noted that actual normal cost is less than six percent of payroll for younger members and over twenty percent of payroll for older members. If primarily younger workers select a DC plan, the average costs for the remaining members will increase.[57] The report concluded that financially it would not be possible to offer employees a choice between the two options.

The Committee was also charged with evaluating the fairness to diverse employee groups of each retirement structure. Clearly, the DB plan favors career employees and the DC plan favors the short-term employees. However, as demonstrated by Colorado's recent restructuring of its retirement system, some changes can be made within a DB structure to increase portability, and thereby enhance benefits for shorter term workers. In fact, Texas has already implemented some features which

enhance portability such as reciprocal agreements with other state and local retirement plans. Another issue that is important to note concerning fairness is that a DB plan allows the State flexibility in adjusting benefits. For example, if inflation is high and the buying power of retirees is eroding, the State can implement a cost of living adjustment. In addition, certain careers in the public sector typically have a shorter tenure such as law enforcement and firefighters. Having a DB structure, allows the State to subsidize early retirement for these types of employees. This is not possible under a DC plan. Furthermore, with a DB structure, the State can better influence retirement patterns. For example, when certain Texas public employees faced layoffs due to privatization, they were offered early retirement incentives. Again, these options would not be possible with a DC plan.

Recommendations

1. Maintain the current DB structure of the ERS and TRS retirement programs.

According to the General Accounting Office (GAO), there are three key sources of retirement income: Social Security, private pensions, and savings. In 1997, Americans saved only 3.9 percent of their disposable income.[58] This low-savings rate increases reliance on employer-sponsored pension plans. For the majority of Texas school personnel, this is particularly important because many of them do not participate in the Social Security program. Of the 1043 school districts in Texas, 21 provide Social Security coverage to all of their employees and 26 provide Social Security coverage to select employees.[59] As a result, the TRS pension plan provides them with a guaranteed income that would otherwise not exist.

Furthermore, the DB plan provides more retirement benefits for the dollar. In a DB plan, about 80 percent of the accrued dollars are spent on normal retirement benefits for career employees. By comparison, approximately one-half of the dollars collected for DC plans fund retirement benefits. The remainder funds loans, termination payments and early retirements.[60]

In addition, the DB structure allows the state to accomplish various objectives with the retirement program. For example, the DB plan structure provides experienced, highly trained employees strong incentive to remain with their employer. As the State currently struggles to retain employees, a retirement system that rewards tenure and longevity better meets the needs of the State.

2. When fund performance exceeds liabilities, look for ways to enhance benefits for employees.

One of the criticisms of DB plans is that employees often do not reap the rewards of strong market performance. There are several benefit enhancements that have been implemented in Texas to share the rewards of the strong market performance. This past session, for example, the Legislature increased the TRS multiplier. The State should continue to look at ways to enhance benefits without jeopardizing the long-term ability of the fund to meet obligations. This next session, for example, the State should consider the feasibility of increasing the TRS multiplier. The State should also look at ways to increase portability and benefits for short-term employees. For example, the feasibility of increasing the interest rate payment on withdrawn contributions at ERS should be considered. These benefit enhancements should only be enacted if they do not jeopardize the ability of the State to meet obligations.

3. **Encourage participation in ERS' optional deferred compensation plan.**

Over the past year, ERS has made improvements in the optional 401(k) and 457 plans. Membership in these plans is high, particularly in light of the fact that there is no State contribution. Several states have implemented programs to augment their existing DB plans by providing a match to participants in the optional deferred compensation plans. Doing so preserves the security of the DB fund, but increases portability for short-term employees. This should only be considered in Texas if the match was provided in addition to the current DB plan funding.

4. **Explore the need and cost of establishing a similar, optional deferred compensation plan at TRS.**

The Committee received testimony that the 401(k) and 403(b) plans offered by the local school districts vary greatly in cost and performance. The need for a centralized, optional plan at TRS should be further explored. If it is determined that such a plan should be established, funding should not supplant existing funding of the TRS retirement system. In fact, the feasibility of making this plan self-supporting should be analyzed. If such a plan were established, providing an employer match, whether from school districts or the State, would greatly enhance participation. In addition, this structure would provide teachers the stability of a DB plan and the portability of a DC plan.

RE-EMPLOYMENT

RE-EMPLOYMENT

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with considering a general policy for the state regarding the re-employment of people who have retired under a state retirement plan. For the purposes of this report, we will be examining the re-employment policies of the Employees Retirement System and the Teacher Retirement System. Currently these retirement systems have different policies relating to their employees returning to work. These differences are based on the differences in work schedules for employees in the two systems, as well as on the availability of qualified employees.

The issue of re-employment following retirement is a timely one. Many private sector employers are currently revisiting their retirement arrangements. Demographics are forcing employers to adopt changes to their retirement policies. The reality of the situation is that as baby boomers retire, employers are having a difficult time filling those vacancies. The statistics underscore the need to plan for an aging workforce. Throughout the 1970s, the U.S. labor supply grew at a pace of more than 2 percent per year, peaking at more than 3 percent in 1978. In contrast, today's labor supply is expanding at an average rate of 1 percent per year, and that number is projected to drop below 1 percent by 2004. According to consulting firm, Watson Wyatt, what this means for employers is that from 1996 to 2006, the number of workers aged 25 to 34 will drop by nearly 9 percent, while the number of workers aged 55 to 64 will increase by more than 50 percent.[61]

The "buzz word" among human resources professionals on how to deal with the shifting demographics is "phased retirement," defined as allowing employees approaching normal retirement age to reduce their work hours and/or job responsibilities to gradually ease into full retirement. These phased retirement arrangements can allow employers to retain valued workers longer than if the only option given to the employee was full-retirement. In addition to "phased retirement," companies are undertaking various initiatives to continue to utilize their most experienced workers. For example, companies such as Chevron, Prudential Insurance and Monsanto are tailoring consulting contracts and part-time assignments to accommodate older workers. In addition, they are bringing employees out of retirement to fill critical gaps in knowledge and experience.[62]

Teacher Retirement System

Texas classrooms are feeling the squeeze from the combination of an aging population and a competition for qualified workers. Presently, Texas is facing a severe shortage in the number of available certified teachers. It is estimated that there are currently over 40,000 public school teaching vacancies and that for FY 2000, only approximately 13,000 new teachers will receive state certification.[63] There is also the problem of a high turnover rate among teachers as many public school teachers are being lured into the private sector by higher paying jobs with increased benefits. In the 1997-98 school year alone, over 57,000 teachers, approximately 20 percent, left the teaching profession.[64] Since the pool of certified teachers does not keep pace with demand, the Legislature has acted to help school administrators tap into a valuable talent pool: retired teachers.

Return to Work Provisions for TRS

State law requires a one-month separation from employment in Texas public schools for employees retiring under the TRS System. After completing the required one-month separation of service, an individual may return to work in Texas public education under the following conditions without affecting his or her annuity payments:

- As a substitute at no more than the employer's daily rate of substitute pay for an unlimited number of days during a school year; or
- On a one-half time basis or less during any month; or
- Excluding all other Texas public school employment, retirees may work up to six months on a full-time basis provided that:
  1. the full-time employment is performed beginning in the school year after the retirement date (for example, October after an August retirement);
  2. working any part of a month counts as a month; and
  3. they work no more than six months during the school year. Employment as a substitute or on a one-half time or less basis will be included as part of the six months.

In addition, a TRS retiree may return to work in Texas public education, with a reduction in benefits, under certain conditions. A retiree will forfeit annuity payment for any months in which they:

- work full-time during the school year in which they retire as a member; or
- work full-time for more than six months during the school year. They will lose the annuity payment for any month in which they work in excess of the six months; or
- work part of the month as a substitute and part of the same month on a one half-time basis; or
- work as a substitute or on a one-half time basis in addition to the six-month, full-time employment exception during the same school year.

With the passage of SB 1128 by the 76th Legislature, beginning September 1, 1999, certain retirees are allowed to return to teaching full-time in acute shortage areas, as defined by the Commissioner of Education, without a reduction in their annuity as long as they:

- are a classroom teacher;
- have retired with no reduction in benefit due to early age;
- and have a break of 12 consecutive months in public school service since their retirement date.
- In addition, retirees must meet certification requirements as established by the State Board of Educator Certification. As of March 7, 2000, areas of acute shortage were defined as: Mathematics (secondary), Science (secondary), Special Education (all levels), Languages other than English (secondary), Bilingual/English as a Second Language (all levels), and Technology Applications (secondary).[65] This definition provides an appeals process by which a district may have additional subject areas included in the definition of "acute shortage area."

Utilization of Return to Work Exceptions

For the 1999-2000 school year, a total of 11,045 TRS retirees returned to employment with the public schools in some capacity:

Return to Work exception	1999-2000 school year
Substitutes	5,711
Part-time, ½ time, or less	3,592
Full-time, 6 mos. exception	1,185
Full-time, 6 mos. exception, w/ Annuity suspended after 6 mos	788
Full-time, Acute Shortage Area	129
Total	**11,405**

It is important to note that the number of retired teachers eligible to return to the classroom under the provisions of SB 1128 is not significant enough to be considered a solution to the teacher shortage problem. TRS estimates that, of its population of retirees, approximately 10,000 would be eligible to return to work under SB1128, provided they are certified in an acute teacher shortage area. It is also estimated that roughly 70 percent of the estimated 10,000 are over the age of 65.[66] Though retired teachers may be an extremely valuable resource for filling classroom teaching vacancies, we should not look to this population to play too significant a role in solving the teacher shortage problem.

Employees Retirement System

Employee retention problems are not limited to the classroom. The state of Texas also faces high turnover rates among state employees. According to a report by the Office of the State Auditor, the statewide turnover rate for fiscal year 2000 was 17.58 percent for full-time classified state employees. This figure is significantly higher than the average rate of 15 percent reported by state governments bordering Texas and the average rate of 12 percent reported by local governments.[67] One of the factors contributing to this high turnover rate is the loss of state employees to the private sector. As the economy remains strong, particularly in the Greater Austin area, where many state employee jobs are located, the state continues to face the loss of experienced employees who defect to the private sector for higher paying jobs. The state has experienced turnover rates as high as 30 percent at 19 of its 131 agencies.

Aging of the Workforce

Another issue that the state must be mindful of is the number of employees who are reaching retirement age. As a greater percentage of employees become retirement-eligible, the problem of employee retention will only be compounded by the loss of experienced staff to retirement. Analysis of the State's workforce completed by the State Auditor's Office reveals that the State's workforce is currently older than both the U.S. and Texas' projected median age for 2030. The average state employee, excluding higher education employees, is 40.6 years old and has 8.22 years experience. Currently, the majority of state employees are between 40-50 years of age. This age group comprises 31 percent of the State's workforce.

The Committee requested that ERS calculate how many in the current state workforce will reach retirement

eligibility over the next five years. Between now and FY 2005, 16 percent of the State's workforce will be eligible to retire. Some of the largest agencies have even higher percentages. A sampling of these figures follows:

Agency	Workforce as of 8/29/00	Employees Eligible to Retire by 8/31/2005	Percentage of Workforce
State Total	**153,326**	**24,653**	**16**
Department of Criminal Justice	40,748	5,870	14
Department of Mental Health and Mental Retardation	21,054	3,152	15
Department of Transportation	15,696	2,911	19
Workforce Commission	3,720	839	23
Department of Public Safety	6,939	2,001	29

Many agencies are taking steps to prepare for the large number of employees reaching retirement eligibility. For example, at a hearing of the General Government Subcommittee of the House Appropriations Committee, Texas Workforce Commission's Executive Director, Cassie Carlson Reed, testified that the TWC's turnover rate for FY1999 was 32.14 percent. Though much of the turnover rate was due to the transfer of certain operations out of the agency, the agency's turnover adjusted for service transfer was still 17.34 percent - a high figure, nonetheless. Reed also noted that between 2001 - 2005, approximately 25 percent of TWC's workforce will be eligible for retirement. Of particular concern is that many of the retirement-eligible employees are managers. In San Antonio, all TWC supervisors will be retirement-eligible during this time period.

In an attempt to address the problem, TWC plans to implement a pilot project in its San Antonio offices, to train new managers and ease the transition of losing current supervisors to retirement. The project will include management development courses, open to all employees in the area. The agency has also implemented on-line exit surveys to determine reasons why employees are leaving the agency. The goals of the agency are to increase training for staff and supervisors and improve communication within the agency. TWC plans to present the results of its pilot project at the State Auditor's professional development seminar in October 2000.

The State Auditor's Office notes that TWC is not alone in this predicament. They warn that the state is facing a massive "brain drain" as the aging workforce retires in growing numbers. In fact, retirement was the second most common reason for state employee turnover in FY 1999.[68]

Return to Work

One possible resource for state agencies to utilize in filling vacancies is retired state employees. Currently, state law allows retirees to return to work provided at least one full calendar month has passed since their date of retirement. Retirees may also continue to receive their annuity for the first nine months of their re-employment within a fiscal year.[69] However, retirees have not returned to state employment in significant numbers. For fiscal year 1999, only 555 of the State's more than 150,000 state employees had returned to work under the State's return-to-work provisions for ERS retirees.[70] (see Attachment A)

There are many advantages to the State in re-hiring retired state workers:

- The State does not incur the costs of training a new employee;
- The State does not make a contribution to the employee's retirement;
- The State does not have to pay for health insurance for a new employee; and
- Retirees bring valuable experience to their positions, that in many cases can be very difficult, if not impossible, to replace.

Despite the advantages of re-hiring retirees, it is important to note that the focus of the State should be on initiatives to retain its younger employees. According to a study by the State Auditor, the costs of employee turnover for the state are conservatively estimated at between $127 and $254 million for FY99[71]. These costs include recruiting, training and lost productivity. Though re-employment of retirees has its advantages, it is not a long-term solution to the State's employee shortage problem.

Analysis of the Problem

The issue before the committee is whether the differences in return to work provisions between ERS and TRS are justified, and on a larger scale, whether the current state policy is adequate to meet the needs of a changing workforce.

Recommendations

1. Maintain the current return to work provisions at ERS and TRS.

Both school districts and state agencies have adequate flexibility to rehire former employees. Though laws concerning return to work are slightly different at ERS and TRS, the differences between those requirements are justified. The teacher shortage has reached a critical point, thereby justifying changes adopted in SB 1128 which apply to a limited number of teachers.

Once again, for both the State and local school districts, re-employment policies alone cannot have a significant impact on worker shortages. Salary and benefits are critical issues for worker retention. Nevertheless, the current laws allow agencies and school districts sufficient flexibility to tap into this valuable pool. It is also significant to note that nothing prevents state agencies and school districts from utilizing some of the "phased retirement" techniques that are being employed by private employers.

2. Continue to monitor the effectiveness of return-to-work provisions in SB 1128.

There has been much discussion about the 12 month lay-out requirement contained in SB 1128. The Committee received testimony requesting that the Legislature reduce or eliminate that requirement altogether. The Legislature seeks to provide school administrators the greatest

flexibility in hiring or re-hiring school teachers; however, the 12-month layout serves to:

- Provide TRS a defensible position against the Internal Revenue Service (IRS) prohibition of distributions from pension plans to participants who have not separated from service with the employer, also referred to as in-service distributions; and
- Mitigate the associated actuarial costs.

The Committee received legal opinions from the Texas Legislative Council and the law firm of Clark, Thomas & Winters, consultants to TRS, that concluded it is impossible to predict whether or not a shorter lay-out requirement would be viewed by the IRS as a violation of the in-service distribution rule. A violation of the in-service distribution prohibition could jeopardize the tax qualified status of the fund. Because teachers typically work on a ten-month contract with a routine period of separation of 90 days, a 30 day lay-out provision could likely violate IRS regulations. The adequacy of a six month lay-out restriction is unknown. To have a definitive answer, TRS could request a private letter ruling on the subject from the IRS. A waiting period for an answer on a private letter ruling often exceeds six months. In addition, the typical fee for preparation of the application is between $5,000 and $10,000. The filing fee for this application is more than $2,000.[72] Because this process is slow, the Legislature could shorten the lay-out period and make implementation of the legislation contingent upon receiving a favorable private letter ruling from the IRS. The Committee cautions that any reduction in the lay-out requirement should be carefully constructed so that the tax-qualified status of the fund is not jeopardized. The lay-out provision should be adequate to demonstrate a clear break in service.

Another issue that prevents the Committee from making a definitive decision on a reduction in the lay-out provision is the impact on the retirement fund. The Committee received testimony that TRS actuaries had determined that a shorter lay-out requirement would create an incentive for teachers to retire and then return to work. This change in behavior of TRS members would financially impact the fund. The actuaries believe that the one year break in service requirement mitigates changes in behavior. As a result, the adoption of a shorter lay-out provision could prevent legislators from being able to adopt other changes, such as an increase in the TRS multiplier, that would benefit all current and retired school employees. The Committee recommends that as changes to the retirement system are considered, the priority should be on providing enhancements that benefit all members.

3. Amend return to work provisions contained in SB 1128 to allow the local school districts to determine critical shortage areas.

The Legislature stipulated that only those educators certified to teach in acute shortage areas, as defined by TEA, could return to work under the provisions of SB 1128. As previously stated, areas of acute shortage were defined as: Mathematics (secondary), Science (secondary), Special Education (all levels), Languages other than English (secondary), Bilingual/English as a Second Language (all levels), and Technology Applications (secondary).[73] These shortage areas were determined through a survey process in which TEA collaborated with the Texas Association of School Personnel Administrators. In addition, the Commissioner of Education wanted to provide local districts with flexibility in determining their acute shortage areas, and therefore, a waiver process was established. To date, five school districts have applied for and received waivers. The Committee recommends that because of the variations between school districts in Texas, local school districts should have the latitude to determine where their shortages exist without having to

request a waiver from TEA. TEA notifies all school districts of the critical shortage areas, as well as the waiver process. Nevertheless, the low number of school districts that have petitioned for a waiver indicates that, perhaps, its availability is not widely known. This problem could be alleviated by allowing districts to use their own knowledge of local needs to determine acute shortage areas.

ATTACHMENT A

Employees Retirement System

Return to Work Totals FY-2000

State Agency	Retired State Employees RTW per Agency	Agency Size
Senate	4	618
House of Representatives	7	707
Legislative Council	1	416
Court of Criminal Appeals	2	57
Office of Court Administration	1	126
Governor's Office, Trustee Program	2	47
Governor's Office	4	135
Attorney General	10	3,650
State Purchasing and General Services	4	737
Comptroller of Public Accounts	20	2,658
General Land Office	5	554
Secretary of State	1	238
State Auditor's Office	1	228
State Securities Board	1	79
Commission for the Blind	6	618
Texas Workforce Commission	24	3,704
Department of Human Services	68	14,161
Texas Rehabilitation Commission	25	2,426
State Pension Review Board	1	4
TX Commission on Human Rights	2	43
Office of Administrative Hearing	1	113
Texas Lottery	1	310
TX Veterans Commission	1	89
Department of Public Safety	55	7,024
TX Workers' Compensation Commission	1	1,052
Board of Insurance	8	1,012
Railroad Commission	1	801
State Board of Public Accountancy	1	36
Board of Private Investigators	1	45
Texas Department of Health	22	5,398
Board of Medical Examiners	1	96
Commission on Alcoholism	2	14

Health and Human Services	1	172
Department of Protective & Regulatory Service	17	6,682
Department of Agriculture	1	477
State Board of Veterinary Medical Examiners	1	9
TX Natural Resource Conservation Commission	10	2,879
Soil and Water Conservation Board	1	61
Department of Transportation	48	14,621
Department of MH/MR	107	21,774
Texas Juvenile Probation	1	50
Texas Youth Commission	14	4,844
TX Department of Criminal Justice	43	41,097
School for the Blind and Visually Impaired	2	454
School for the Deaf	1	517
TX Higher Education Coordinating Board	1	231
Parks and Wildlife Department	20	2,776
Texas Historical Commission	2	94
Texas-Cooperative Inspection Program	1	64
Total	555	151,821

ANNUITY OPTIONS

ANNUITY OPTIONS

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with reviewing the need for multiple cash and reduced annuity options such as "lump sum" and "DROP" plans.

What is a DROP?

A Deferred Retirement Option Program (DROP) is an optional program under a defined benefit retirement plan which allows retiring members to get a portion of their retirement benefit in a lump sum in exchange for a lifetime reduction in monthly benefits.

History of DROPs

The first DROPs were established in the early 1980s in Louisiana. Many retirement systems in Louisiana offered retirement benefits at a relatively early age. The vast majority of participants in these plans were retiring as soon as they were eligible. Employees retiring at an early age receive their benefits over a long period of time. This increases actuarial costs for a plan. In an effort to reduce these costs, the initial DROPs were offered to encourage participants to continue working past their earliest possible retirement date.

Since their introduction, DROP plans have evolved to accomplish a variety of objectives. DROPs can be designed to accomplish goals, such as: increasing portability; inducing changes in retirement patterns - either to get people to work longer or retire earlier; and to allow an individual to create an estate within a defined benefit system.

DROPs have been increasing in popularity, particularly among police and firefighter retirement systems. Since their inception, three basic types of plans have evolved; each of which offers a reduced monthly annuity in exchange for a lump sum payment.

1. **Regular DROP (also called a Forward DROP):** Under a Regular DROP, an individual who is eligible for retirement can sign a binding agreement with an employer to complete an additional period of service, usually between two and five years. At the conclusion of the additional period of service, the individual is paid a monthly benefit based on the retirement formula (which factors in salary, years of service and a multiplier) in effect on the date of entry into the DROP. The individual also receives a lump-sum payment equal to the accumulation of the DROP monthly benefit, with some interest, from the date they entered the DROP until their retirement. The member is still performing the duties of an active employee, but they have "locked in" their benefit and pay levels for calculation of their retirement annuity. No pay increases or benefit increases are considered after a member elects into the DROP, resulting in a lower lifetime monthly benefit.[74]
2. **Immediate DROP (also called a Partial Lump Sum Option):** An Immediate DROP reduces the monthly retirement benefit by a fixed percentage and provides an individual with a lump sum payment. This option is selected at retirement, and no additional service is required.
3. **Retroactive DROP (also called a Back DROP or Reverse DROP):** A Retroactive DROP

allows participants to select a DROP after attaining eligibility for retirement. At that time, a beginning period of the DROP is selected by the individual. The individual is paid a monthly benefit based on the retirement formula (which factors in salary, years of service and a multiplier) in effect at the time selected for entry into the Retroactive DROP. The individual also receives a lump-sum payment equal to the accumulation of the DROP monthly benefit plus interest, calculated from the date selected for entry into the DROP.

Issues to Consider in Designing a DROP

Leon F. "Rocky" Joyner, Jr., Vice President of The Segal Company, notes that in designing a DROP, it is necessary to:

- Define specific goals and expectations for the DROP.
- Review plan retirement patterns and assess the impact that the DROP may have on them.
- Consider the age and service characteristics of the group and forecast how the DROP may change them.
- Consider the impact changes in retirement patterns may have on salary and training needs for active employees.[75]

Impact of Participation in a DROP for Members

A DROP program has advantages and disadvantages for participants. It is important to note that these advantages and disadvantages depend on the design of the DROP program and will not necessarily apply to the programs offered by ERS or TRS.

Advantages:

- DROPs allow retirees flexibility in planning for their retirement. A lump-sum payment can help cover education costs, medical costs, or other large expenditures. In addition, these funds can be rolled over into an eligible plan or an IRA.
- DROPs allow retirees to have the stability of a lifetime monthly benefit combined with a lump-sum payment which allows retirees to create an estate within the defined benefit structure.
- Individuals who have reached the limit on their benefit accruals, or who do not expect earnings to increase significantly during their final years of employment, may increase their overall retirement benefit by participating in a DROP.

Disadvantages:

- If an individual does not use lump sums received through a DROP program prudently, he or she may face financial shortfalls because his or her monthly benefit has been reduced through selection of a DROP.
- In some DROP programs, the individual must agree to terminate employment within a fixed number of years. This agreement is usually irrevocable.
- An individual may forgo a significant pension benefit increase if his or her salary increases after they have selected participation in a Forward DROP.

- In some DROP programs, payments to the DROP account may be less than 100 percent of the contribution in order to make the DROP cost neutral.
- May lessen post-retirement increases based on initial retirement calculations.
- A DROP distribution could potentially result in a higher tax liability for an individual.

Impact of DROP to the Retirement System and Employer

Advantages:

- DROPs can encourage experienced employees to stay on the job longer. This can save employers costs associated with hiring and training new employees.
- Regular DROPs are designed to change work patterns by providing an incentive for people to work longer. Under the current economic climate with low unemployment and difficulty attracting employees, these DROPs provide an incentive for individuals eligible for retirement to continue working.
- The additional flexibility afforded to individuals with a DROP option may improve employee satisfaction with his or her retirement benefits.

Disadvantages:

- Changes in the economic climate can necessitate changes in employment incentive structures. For example, during periods of low unemployment, a DROP could be designed to retain existing employees. When the climate shifts, an employer may need a plan that encourages retirement. The danger of a DROP plan for state retirement systems is that changes to the plan require legislative action. The economy is prone to sudden changes, and legislative changes would be unable to keep pace.
- Administering DROPs requires additional record keeping, staff training and member communication. This may result in higher administrative costs.
- The DROP is not inherently cost neutral. The program may increase cost to the retirement system.
- Higher contributions to a retirement fund may be necessary if retirement patterns do not change as predicted in the actuarial assumptions.

Impact of Multiple DROPs in a Single Retirement System:

Advantages:

- Allows retirement system members additional flexibility in designing a retirement plan that meets their individual needs.

Disadvantages:

- Communication of the multiple programs is an additional challenge for plan administrator.

<u>DROPs in Texas</u>

In Texas, both the Employees Retirement System and the Teachers Retirement System offer participants DROP options. In both systems, the programs are designed to be cost neutral.

Employees Retirement System (ERS)

During the 76th Legislature, SB 1130 authorized the creation of a Partial Lump Sum Option (PLSO) for ERS members. The PLSO is an Immediate DROP. The program went into effect on January 1, 2000, and it allows new retirees to request from one to 36 months of their standard annuity as a lump sum payment at retirement. The standard monthly annuity is then reduced using actuarial reduction factors (see Attachment A).

ERS Experience

Partial Lump Sum Option (PLSO)

January - August 2000

Number of Retirees	2532
Number of PLSOs	847
Percent of PLSOs	33%
$ Amount of PLSOs	$35,705,250
Number Taking Rollover Option	316
Percent Taking Rollover Option	37%
Number Taking Lump Sum Distribution	621
Percent Taking Lump Sum Distribution	73%
Average Salary	$2,858
Average Standard Annuity	$1,604
Average Number of PLSO Months Taken	26
Average PLSO Amount	$42,155
Average Reduced Annuity	$1,286

Teacher Retirement System (TRS)

TRS is the only state retirement system in Texas to offer its members multiple DROP options. Two cash and reduced annuity options are available to TRS members, but members cannot participate in both, they must select one. The "Deferred Retirement Option Plan," a Regular DROP program, was authorized during the 75th Legislative Session. Under this program, a member continues working after entering the program and accumulates cash for withdrawal at retirement in addition to monthly annuity. In order to be eligible for the TRS "Deferred Retirement Option Plan," a TRS participant must have at least twenty-five years of service; they must be eligible for unreduced service annuity (no early retirement); and they must be an active contributing member. Members may elect to participate in DROP for a period of one to five

years, in yearly increments. (For a full explanation of the TRS DROP program, see Attachment B).

The "Partial Lump Sum Option," an Immediate DROP, was adopted by the 76th Legislature in SB 1128. With the PLSO, at retirement, a retiree selects a partial amount of lump-sum cash, and his or her standard monthly annuity is then reduced using established percentages (see Attachment C).

In addition, with the passage of SB 1128, the 76th Legislature amended the regular DROP by reducing the amount deposited in an individual's DROP account from 79 percent to 60 percent of his or her retirement contribution. This change was necessary because legislators prioritized raising the multiplier to the highest level possible without jeopardizing the soundness of the fund. During the session, this committee requested that TRS demonstrate what would happen if the multiplier was increased to 2.2 percent and the DROP program remained unchanged. Watson Wyatt, consulting actuary for TRS, determined that under this scenario the State would have to increase its contribution rate from the current level of 6.0 percent to 6.71 percent in order to amortize the unfunded liability within 30 years[76]. Increasing the multiplier was given higher priority because unlike the DROP, an increase in the multiplier enhances benefits for all retired and active TRS members.

TRS Experience

Deferred Retirement Option (DROP) and

Partial Lump Sum Option (PLSO)

as of 8/31/2000

DROP

Number of eligible members	34,231
Number of members participating	5,131 at 79 % contribution 392 at 60% contribution 5,523
Percent of eligible members	15% at 79% contribution 1% at 60% contribution 16%

Note: 25% of members participating in DROP as of 8/31/2000 revoked during FY2000.

PLSO (during FY 2000)

Number of eligible retirees	10,222
Number of PLSO participants	3,292

Percent of eligible retirees	32%
$ amount distributed in FY 2000	$184 million

Recommendations

1. **Continue the existing programs which provide cash and reduced annuities for retirees at TRS and ERS.**

   Utilization of the Partial Lump Sum Option at ERS and the Partial Lump Sum and Deferred Retirement Option Program at TRS has been high, and employees have expressed their satisfaction with the existing options. The existence of these annuity options allows retirees more flexibility in planning for their retirement.

2. **If enhancements are made to existing retirement programs, the priority should be to make changes which will benefit all retired and active members.**

   Although participation in TRS' DROP has declined substantially since changes were enacted in the 76th Session which lowered the percentage paid out, the Committee received testimony that participants in the TRS system favored having multiple options. Some testimony was received advocating an increase in TRS' DROP percentage. The Committee cautions that it may be a more prudent for state policy to reward all employees rather than a select few who participate in a reduced annuity program. Therefore, the Committee recommends that benefit enhancements enacted by the Legislature should be distributed equitably, such as with an increased multiplier.

   In addition, the Legislature should continue monitoring the efficiency of multiple reduced annuity options at TRS. The Committee received testimony that consumers prefer having multiple DROP options, however, since the Legislature adopted changes to the program in the 76th Session, utilization of TRS' DROP has been extremely low. At some point, low participation in this program may not justify the additional administrative expense of offering both DROP options, particularly when program objectives are so similar.

ATTACHMENT A

Employees Retirement System

Lump Sum Reduction Factors

Example: You are age 60 and want a lump sum payment of 24 months of your Standard Annuity. Look under the column "Age" for your age, 60. Look to the right under "24 Months" for the reduction factor, 0.80401. Multiply 0.80401 times your Standard Annuity to determine your gross monthly annuity.

Age	12 Months	24 Months	36 Months
45	0.91604	0.83208	0.74813
46	0.91551	0.83102	0.74653
47	0.91494	0.82988	0.74482
48	0.91432	0.82865	0.74297
49	0.91366	0.82732	0.74098
50	0.91295	0.82589	0.73884
51	0.91218	0.82435	0.73653
52	0.91135	0.82270	0.73404
53	0.91046	0.82091	0.73137
54	0.90950	0.81900	0.72850
55	0.90846	0.81693	0.72539
56	0.90735	0.81470	0.72205
57	0.90615	0.80229	0.71844
58	0.90486	0.80972	0.71458
59	0.90348	0.80696	0.71044
60	0.90200	0.80401	0.70601
61	0.90042	0.80085	0.70127
62	0.89874	0.79748	0.69621
63	0.89694	0.79388	0.69083
64	0.89503	0.79007	0.68510
65	0.89301	0.78601	0.67902
66	0.89086	0.78171	0.67257
67	0.88857	0.77714	0.66571

68	0.88613	0.77226	0.65839
Age	**12 Months**	**24 Months**	**36 Months**
69	0.88350	0.77672	0.65051
70	0.88066	0.76133	0.64199
71	0.87757	0.75515	0.63272
72	0.87422	0.74844	0.62266
73	0.87059	0.74117	0.61176
74	0.86665	0.73330	0.59995
75	0.86237	0.72474	0.58711

Note: Although the table shows reduction factors for 12, 24 and 36 months, lump sums are available to eligible retirees in amounts from 1 to 36 months.

ATTACHMENT B

Teacher Retirement System

Explanation of DROP

The Deferred Retirement Option Plan (DROP) is an optional benefit program of the Teacher Retirement System of Texas (TRS) which offers qualified active members a way, during their working years, to accumulate funds in a special DROP account for distribution at retirement. Participating members may elect to receive their distribution as one lump sum payment or in periodic installments.

Eligibility Criteria

Active TRS members are eligible to participate in the plan if they meet all three of the following conditions. They must:

- be active contributing members;
- be eligible for a service retirement annuity that is not reduced for early age; and
- have at least 25 years of service credit in TRS.

Determining a Standard Annuity for DROP

The monthly deposit to a member's DROP account is 60 percent of the calculated monthly standard annuity for those entering DROP on or after September 1, 1999. The standard annuity is determined by multiplying a member's total years of service credit by 2.2 percent and then multiplying that amount by the average of the member's three highest salaries (creditable compensation). This results in an annual standard annuity which is divided by 12 to determine the monthly standard annuity. The standard annuity determined for DROP is also the standard annuity upon which the member's future retirement benefits will be based.

Both earned salary and service credit are important factors in determining a member's DROP deposits and future retirement benefits. To calculate the amount of DROP deposits, TRS calculates a member's standard annuity using only the three highest years' salaries earned through the last day of the month immediately preceding the DROP participation date. Years of service credit are determined as of the last day of the month immediately preceding the DROP participation date. TRS relies on information from employers to make these determinations.

Earned Salary

Earned salary for the school year in which the member begins DROP participation is determined as of the last day of the month immediately preceding the DROP participation date. Consider the following examples:

- If the effective date of participation is February 1, only salary earned through January 31 would be considered for that school year. It is not likely that six months of salary would produce one of the three highest annual salaries to be included in the calculation.
- If the effective date of participation is June 1, only salary earned through May 31 would be considered in determining the three years of highest salary. If members complete their required number of contract days by May 31 and have elected to have their salaries spread over 12 months,

their "earned" salary for that school year would include all remaining amounts due to be paid after May 31.

If members plan to complete their current school year before entering DROP and they wish to have their entire school year's salary considered, they should designate a DROP effective date no earlier than the first day of the month following the month in which they complete the days of service required by their contract or work agreement. Their election must be mailed in time to be received at TRS before the date of participation.

Service Credit

A member earns a year of TRS service credit for each school year in which the member works in an eligible position or is on paid leave for at least four and one-half months, a full semester of more than four calendar months, or at least 90 work days. For example:

A member with a July 1 contract start date earns a credited year of service based on four and one-half months by November 15, provided there are no deductions in salary for absences.

A member who completes a full semester of more than four calendar months by December 31 earns a creditable year by December 31, provided the member is an employee paid for every day of the semester.

A member who is employed in a year-round school must work or be paid for at least 90 work days in a school year to earn a year of service credit.

If members wish to have the current school year count as a year of service credit for calculation of their DROP deposits and future retirement benefits, they should designate a DROP effective date no earlier than the first day of the month following the month in which they complete the days of service required by their contract or work agreement. Their election must be mailed in time to be received by TRS before the date of participation.

Special Service Credit

Members may increase their years of service by purchasing any eligible special service credit. The most common types of special service are active duty military, out-of-state public education, withdrawn TRS service, and substitute service. An election to participate in the DROP constitutes a deadline for the purchase of special service credit. Members who are eligible to purchase special service and wish to receive credit must make payment in full for that service before their DROP participation date.

Note: Service credit in the Employees Retirement System (ERS) is not eligible for transfer to TRS for the purpose of determining DROP eligibility or deposits.

The Effective Date of the DROP Election

The effective date of a member's DROP election, also referred to as the DROP participation date, is the first day of the month designated on the DROP election form, or the first day of the month following the month in which TRS receives the election form, whichever is later.

IMPORTANT CONSIDERATIONS BEFORE ELECTING TO PARTICIPATE IN DROP

A DROP Election is Irrevocable

TRS law specifies that when members enroll in DROP, they do so as an irrevocable, one-time election. (The 76th Legislature approved one exception to this law. This exception provides DROP participants enrolled on or before August 31, 1999, with a one-year window from September 1, 1999, through August 31, 2000, in which DROP participation may be revoked). As a result, it is extremely important that members determine the suitability of DROP for their retirement needs before they submit form TRS 567, "Election to Participate in the Deferred Retirement Option Plan (DROP)." They should also remember that their election to participate in DROP becomes their deadline for purchasing special service credit.

Participation Period

Members may elect to participate in DROP for a period of one to five years, in yearly increments. Only three events can terminate DROP participation: (1) retirement, (2) expiration of the participation period, or (3) the member's death.

Member Contributions During DROP

Members participating in DROP continue to make monthly contributions as required by law to TRS during their employment, and this includes the period during DROP participation. However, they no longer earn further service or salary credits for their retirement annuities while participating in DROP.

Interest Earned and Applied

TRS credits interest at the rate of five percent per annum to members' DROP accounts until final distributions are made. The first DROP distribution is due and payable at the same time as the member's first retirement annuity payment. From that point on, monthly distributions are paid on the first of each succeeding month until the DROP account has been fully distributed. Yearly distributions occur on the anniversary due date of the first payment.

Member contributions made during DROP participation are not refundable (except with the one-year window noted above). Contributions made by a member while participating in DROP are not deposited into either the member's contribution account or DROP account. Rather, these contributions are deposited into the retirement reserve account. This account is used to pay all retirement annuities and all death or survivor benefits, including post-retirement benefit increases and other annuity adjustments.

Working After DROP

A member may continue to work after the end of the DROP participation period, if desired. Any additional service credit rendered after the end of DROP participation will be used to calculate a second component to the retirement annuity. This additional component will be based only on the years of service credit and eligible salaries earned after DROP participation ends.

This second component of the annuity is calculated using the same formula as all other TRS retirement annuities. If a member has fewer than three creditable years of service after the end of the DROP participation period, the average salary will be the average for the number of years credited. Post-DROP employment continuation does not require new vesting for benefit purposes.

Distribution Methods

Upon retirement, TRS distributes the accumulated amount in the member's DROP account. The member may select one of the following methods of distribution:

- one lump sum payment;
- yearly or monthly increments over a five-year period; or
- yearly or monthly increments over a 10-year period.

A retiree who first elects a monthly or yearly distribution may later make a one-time election to accelerate installment payments to a lump sum amount representing the remaining DROP account balance.

Designating a DROP Beneficiary

TRS members participating in DROP should separately designate one or more beneficiaries to receive any DROP benefits due in the event of death. Form TRS 11D, "Designation of Beneficiary for Deferred Retirement Option Plan (DROP) Benefits," is included in the DROP election packet. Members should complete and return this form at the same time they submit their DROP election form (TRS 567).

DROP beneficiaries do not need to be the same person(s) named to receive other TRS payments upon the death of the member or annuitant. However, in the absence of a designated DROP beneficiary, DROP distributions will be made according to Texas Law (Section 824.103 of the Texas Government Code).

Death Before Retirement

In the event of the death of a member participating in DROP who has not yet retired, the DROP beneficiary is entitled to receive the accumulated lump sum amount in the DROP account including credited interest. The payment may be eligible for roll over to an IRA.

Death After Retirement

Upon the death of an annuitant who is receiving a DROP distribution in installments, an amount equal to the member's distribution will continue to be made to the DROP beneficiary until the DROP account is fully distributed. As an alternative, the DROP beneficiary may make a one-time election to accelerate payments to a lump sum amount representing the remaining DROP account balance.

Federal Income Tax

Participating in the DROP may have federal income tax consequences. All DROP distributions, except for benefits paid monthly over a 10-year period, have been determined to be "roll over eligible." Members who do not elect to roll over an eligible distribution will have 20 percent federal income tax

withheld from the distribution, as required by federal tax law. More than 20 percent may be withheld at the request of the member. Also, if the member retires before age 59½, a 10 percent early distribution tax may apply to any amounts not rolled over during the period when these distributions are being made. Internal Revenue Service Publication 575, "Pensions and Annuity Income," provides additional information.

If a member elects the 120-month payout, TRS will withhold according to the member's tax withholding preference filed with the system. There still may be a 10 percent tax penalty if the member retires prior to age 59½. Members over age 70½ may have additional tax considerations. The determination of the tax consequences of distributions is a complex matter. Therefore, questions concerning a member's specific tax situation should be referred to a tax professional or financial adviser.

Illustration- How a DROP Account Works

A member is age 55 and has 25 years of service credit as of January 15, 2000. She wants to delay entering DROP until she has earned her full 1999-2000 contract salary. She will earn her full salary by May 31, so she will send her DROP election form to TRS, designating June as her effective date of participation, in time to be received at TRS by May 31. Her best three years' salaries were $28,000, $30,000 and $32,000. The member plans to participate in DROP for three years and to retire on May 31, 2003.

Before calculating the estimated DROP benefit, determine the member's eligibility to participate in DROP. Since this member is age 55 with 25 years of service, she is eligible for an unreduced annuity (because the sum of her age and years of service total at least 80). She has 25 years of covered participation in TRS, and she is an actively employed contributing member.

Because the member meets all three requirements, she is eligible to participate in DROP. Therefore, we can now follow the steps prescribed to estimate the member's DROP benefit.

Step One

List the member's three highest salaries.

$28,000 + $30,000 + $32,000 =

Combined total of $90,000

Step Two

Calculate the member's highest average annual salary by dividing the figure by three.

$90,000 ÷ 3 = $30,000

Step Three

Multiply the member's total years of service credit by 2.2 percent (current multiplier established by law).

25 years x .022 = .55 (total percent)

Step Four

Multiply the total percent by the member's highest three-year average salary.

.55 x $30,000 = $16,500

(This is the member's estimated annual standard annuity.)

Step Five

Divide by 12 to convert the member's estimated annual standard annuity to a monthly amount.

$16,500 ÷ 12 = $1,375

This is not only the amount of the member's annuity for purposes of calculating monthly deposits to the DROP, but it is also the basic standard annuity that determines the amount the member will receive upon retirement. At retirement, an optional reduced annuity payment may be selected to continue benefits to a designated beneficiary.

Step Six

Multiply by .60 (the DROP multiplier) to determine the amount of the member's annuity which will be accrued monthly in her DROP account.

$1,375 x .60 = $825.00

Step Seven

Multiply this amount by the appropriate factor listed below for three years of participation in DROP (38.689326).

$825.00 x 38.689326 = $31,918.69

This is the estimated balance to be accumulated in your DROP account.

Factors for Calculating DROP Balances

Based on the number of months you would select to participate in DROP, choose the corresponding factor, shown below:

# of Months	Factor
12	12.272580
24	25.158795

36	38.689326
48	52.896390
60	67.813813

ATTACHMENT C

Lump Sum Reduction Factors

The 76th Texas Legislature has approved establishment of a new partial lump-sum option program for those TRS members who are eligible for unreduced retirement benefits (not early age retirement) after September 1, 1999, and who are not participating in the Deferred Retirement Option Plan (DROP). Through this new program, qualified members may select a partial lump-sum distribution in addition to a standard or optional retirement annuity when they retire.

Members may select a partial lump-sum distribution not to exceed an amount equal to 36 months of a standard service retirement annuity. When this option is selected, the member's annuity will be actuarially reduced to reflect that distribution and will be computed so that no actuarial loss results to TRS.

A lump-sum amount equal to 12 months of a standard annuity may be taken at the same time as the member's first monthly annuity payment. A lump-sum amount equal to 24 months may be taken in either one or two annual payments. A lump-sum amount equal to 36 months may be taken in one, two or three annual payments.

Percentages shown in the table below will be applied to reduce a member's standard annuity when a partial lump-sum distribution is chosen. For example, a member who retires at age 60 with a $2,000/month annuity and selects a partial lump-sum distribution of 12 months would receive a $24,000 lump-sum distribution ($2,000 x 12) plus an $1,809.20/month reduced annuity ($2,000 x 90.46%). If a member then selects an optional retirement annuity, the option factor will be applied to the reduced standard annuity.

	Percentage of Standard Annuity		
Age	12 Months	24 Months	36 Months
45	91.66	83.32	74.98
46	91.62	83.23	74.85
47	91.57	83.13	74.70
48	91.51	83.03	74.54
49	91.46	82.92	74.37
50	91.40	82.79	74.19
51	91.33	82.66	73.99
52	91.26	82.52	73.78
53	91.18	82.37	73.55
54	91.10	82.20	73.31
55	91.01	82.03	73.04

56	90.92	81.84	72.75

Age	12 Months	24 Months	36 Months
57	90.81	81.63	72.44
58	90.70	81.41	72.11
59	90.58	81.17	71.75
60	90.46	80.91	71.37
61	90.32	80.64	70.95
62	90.24	80.48	70.71
63	90.01	80.03	70.04
64	89.85	79.69	69.54
65	89.67	79.34	69.01
66	89.48	78.96	68.44
67	89.28	78.56	67.84
68	89.06	78.13	67.19
69	88.84	77.67	66.51
70	88.59	77.18	65.77
71	88.32	76.65	64.97
72	88.03	76.07	64.10
73	87.72	75.43	63.15
74	87.37	74.74	62.12
75	87.00	74.00	61.00
76	86.59	73.19	59.78
77	86.15	72.31	58.46
78	85.68	71.35	57.03
79	85.16	70.31	55.47
80	84.59	69.18	53.78
81	83.98	67.96	51.94
82	83.32	66.64	49.96
83	82.61	65.21	47.82
84	81.83	63.67	45.50
85	81.00	62.00	42.99
86	80.09	60.18	40.27
87	79.09	58.19	37.28
88	78.00	56.00	34.00
89	76.81	53.62	30.43
90	75.52	51.04	26.56
91	74.13	48.26	22.39

OVERSIGHT

OVERSIGHT

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with continuing oversight of the state agencies under its jurisdiction. Pursuant to House Rule 3, Section 25, these agencies are: the Office of Fire Fighters' Pension Commissioner, the State Board of Trustees of the Teacher Retirement System, the State Board of Trustees of the Employees' Retirement System, the Board of Trustees of the Texas County and District Retirement System, the Board of Trustees of the Texas Municipal Retirement System, the State Pension Review Board and the State Securities Board. During the 76th Session the Committee had extensive involvement with, and interaction with, all of these agencies except for the State Securities Board. Accordingly, it was determined that the Subcommittee on Oversight would review the State Securities Board.

The State Securities Board (SSB) is a state agency entrusted with the task of administering and enforcing the Texas Securities Act (the Act).[77] The mission of the SSB is to protect Texas investors. Consistent with that primary mission, the agency seeks to ensure a free and competitive securities market for Texas, increase investor confidence, and thereby encourage the formation of capital and the creation of new jobs. To accomplish this mission, the Act gives the SSB the power to investigate suspected violations of the Act; to initiate administrative enforcement proceedings; to refer matters for civil or criminal action; to require registration of nonexempt securities sold in Texas; and to require registration of firms and individuals who sell securities or render advice in the State. For these purposes, the SSB maintains programs for law enforcement, analysis of securities offerings, evaluation of dealer and agent applications, and inspections.

The SSB is overseen by a board composed of three members appointed by the Governor, with the advice and consent of the Senate, for six-year overlapping terms. The Board appoints a Securities Commissioner who serves at its pleasure. The Securities Commissioner serves as the agency's chief administrative officer and supervises the day-to-day activities of the staff. The current Commissioner is Denise Voigt Crawford.

The functions of the SSB are important to ensure the long-term health and viability of capital markets in Texas which rely on investor confidence. The SSB serves to protect investors and facilitate the transparency, efficiency and integrity of capital markets in Texas, thereby maintaining investor confidence. Federal law regulates certain aspects of transactions occurring in interstate commerce and individuals doing business in a number of states. The state and federal regulatory systems form a complementary partnership to maintain effective oversight of the nation's capital markets.

Activities of the Subcommittee

Prior to the first meeting of the Subcommittee, a copy of the State Securities Board's *Self-Evaluation Report* to the Sunset Commission was obtained. This report listed groups and agencies affected by

agency actions or which represented others served by or affected by agency actions. A letter was sent to each of these groups and entities informing them of the hearing and requesting input concerning any issues or concerns regarding the agency. The Subcommittee received responses from entities including Merrill Lynch, the North American Securities Administrators Association Inc., National Association of Securities Dealers, and Consumers Union. All of the entities responding to the Subcommittee's letter, praised the role of the State Securities Board in protecting Texas investors.

Agency staff provided to the Subcommittee information including: the Annual Report to the Governor for Fiscal Year 1998-1999; Supplement to the Annual Report; an Analysis of General Revenue Impact; and information concerning regulatory and enforcement activities of the agency. The Subcommittee met to hear testimony on March 27, 2000.

Issues Presented

Based on input received from the Subcommittee two issues were identified. The first concerns privacy of information obtained by the agency from securities dealers and investment advisors. The second issue concerns the capacity of the agency to investigate and take action against fraudulent dealers and advisors.

Privacy Issues

There may be a conflict with the wording and the intent of the Securities Act. Section 28 of the Act deals with investigations and investigatory materials. This section authorizes the Commissioner to subpoena witnesses and the production of books and documents relating to a matter under the authority of the Board. Section 28 provides that all information obtained in such an investigation shall be treated as confidential by the Commissioner and shall not be disclosed to the public except under order of the court.

On the other hand, to obtain registration as a securities dealer or investment advisor a person must provide to the Securities Commissioner an "Agreement for Maintenance and Inspection of Records." (copy attached) Section 11 of the Securities Act states that all information, papers, documents, instruments and affidavits required by the Act are public records and shall be open to the inspection and examination of any purchaser or prospective purchaser of securities.

The concern arises when the Commissioner obtains private financial records of a dealer's clients under Section 11 and the Agreement, rather than by subpoena under Section 28. That investigation might result in the finding that the dealer's activities are completely lawful. Alternatively, the investigation might determine some impropriety on the part of the dealer. In either circumstance, Section 11 could allow the release of the customer's private financial information.

Investigations and Enforcement

The Subcommittee received input which indicated that the resources of the Board are limited, but the demand for investigations and enforcement of the Securities Act is growing rapidly. The Subcommittee questioned whether the agency had the capacity to meet its responsibilities to investigate complaints, to enforce the Securities Act and to bring actions against dealers and advisors who violated the laws and regulations in a timely manner. Commissioner Crawford provided information concerning the injunctive, receivership, and restitution actions against major frauds during 1998 and 1999. This information included an overview of investigations of various investment fraud schemes resulting in enforcement actions and actions in cooperation with the Consumer Protection Division and various law enforcement agencies.

Recommendations

1. **Add a new provision to the Securities Act to clarify that all inspection and investigation records are private.**

   Such clarification would eliminate any concern regarding the privacy of customer records obtained during an investigation or inspection.

2. **The Committee should examine whether the agency has adequate staff to efficiently handle the number of investigations necessary (a number which is likely to increase as the population of Texas grows and public involvement in securities expands). If workload exceeds the capacity of staff, the Committee should work with the agency and with the Appropriations Committee to determine the appropriate level of staffing.**

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