Trends

Volume 17, No. 2 | May 1998 | Teachers' Retirement System

"Final Report" recommends solutions...

TRS Task Force report: System's financial footing Oklahoma's "most serious" fiscal problem

Citing the Teachers' Retirement System's poor financial condition as "the most serious fiscal problem that faces the State of Oklahoma," the Oklahoma Teachers' Retirement System Task Force has issued its Findings and Recommendations. The 100-plus page report recommends changing the current TRS funding schedule along with new sources of revenue for the ailing System, which serves the State's 110,000 active and retired teachers and school employees.

The report confirms that Oklahoma Teachers' is one of the worst-funded public pension plans in the country and the System's **$4.7** billion unfunded liability is a threat to the State's creditworthiness and negatively affects the quality of education in Oklahoma. The report asserts that paying for the current funding schedule is an inappropriate burden on today's students, teachers and taxpayers.

The 30-member Task Force was composed of retired and active educators from higher education, common schools, and vocational-technical schools and eight business professionals. The Task Force, chaired by Dr. Alexander Holmes, Professor of Economics at the University of Oklahoma, met 11 times between October and March.

"The Task Force heard from more than one dozen witnesses, studied 18 inches of documents by actual measurement, pursued every suggestion with careful research, and debated in open session until consensus could be found,'' Dr. Holmes said. Characterizing the Teachers' Retirement System problem as "a State Problem," the Task Force report states, "The significance of the problem for the future of Oklahoma cannot be overstated."

One of the study group's concerns was the impact TRS' funding schedule will have on local schools. The current schedule provides for increasing employer contributions from 10.5% to 18% of each employee's pay. This will continue until all actuarial liabilities are funded at 100%. According to projections, the System will be fully funded between 2015 and 2020. The Task Force report estimates local schools could see their required contributions increase from **4.8%** of each member's pay to 12.3% or more. Actual numbers will depend on the volatile natural gas tax, which at this time is how the State contributes to the System's reserve fund.

(see *Task* Force, *p. 2)*

From the Executive Secretary...

The Task Force report summarized in this issue is a complex document covering a wide range of issues impacting the Teachers' Retirement System. Each member of the Task Force is to be commended for his or her contributions to the process of identifying and proposing solutions to the problems facing TRS. Each member worked hard and volunteered many hours to travel, meetings and study. Few people will agree with all of the recommendations, but no one can question the sincerity and devotion of these 30 individuals, who came together in an effort to help solve one of the greatest challenges facing the State of Oklahoma. Hopefully, this report will be a catalyst for legislative action to strengthen the System. The study group has done its part. It is now up to the Governor, Legislature and the members of TRS to make any needed changes to ensure that quality education, including a sound retirement program, is the goal of all Oklahomans.

Sincerely,

Tommy C. Beavers

Task Force tackles TRS fiscal future; recommends solutions *(from p. 1)*

While the Legislature has included new money in the school funding formula to cover increased retirement costs in past years, the question before the Task Force was whether this could continue or would local school budgets be ever more tightly squeezed. The Task Force recommends permanently capping local school contributions at **6.05%** of employees' pay, and setting the State's contribution at **5.7%.** This would provide a level **11.75%** contribution from TRS employers and increase the obligation on local schools by **1%** in FY-1999 and **.25** of **1%** in FY-2000. Member contributions would remain at **7%** of total pay. By lowering the overall contribution rate, the System is projected to be 80% funded in **29** years, instead of 100% funded in **19** years.

Task Force members expressed support for funding the liabilities of the Retirement System as quickly as possible and stressed the State must fund the System, directly or indirectly. But the majority believed meeting the current funding schedule may not be possible, given the State's ability to fund TRS along with other state needs. The report concludes, "It is imperative that all increases in employer contributions be funded through legislative appropriations." The report recommends any deposits in the State's Rainy Day Fund not already committed and all windfalls from potential sale of state assets or "tobacco" case settlements be allocated to the System to help pay unfunded accrued actuarial liabilities.

Other recommendations call for continuing the requirement for local schools to make contributions based on employees' pay and eliminating the tax on natural gas as the State's contribution to the Retirement Fund. The report cites the need for local schools to realize the impact local actions, such as increases in salaries, benefits and early retirement incentives, have on the Retirement System. The Task Force report states, "The retirement component of school employees should not be separated from the school's decision process."

An even more controversial recommendation is to un-earmark the gross production **tax** on natural gas, which currently is the State's share of required employer contributions. The Task Force recommends returning this money to the State's General Revenue Fund, contingent on the creation of a "certified" **OTRS** Trust Fund.

Under this plan, money would flow from the General Revenue Fund to the State Treasurer and from the State Treasurer to the **OTRS** Trust Fund. The key to this proposal is the "certified" **OTRS** Trust Fund would receive allocated revenues equal to **5.7%** of the total annual payroll of TRS members before the State Equalization Board certifies the amount available for appropriations by the Legislature. The Task Force believes this will eliminate the problem of a fluctuating dedicated source of revenue and would put **TRS** funding at the highest priority the State can provide.

The Task Force also commended the Teachers' Retirement System for its prudent investment policies and recommended no changes in the System's investment practices. The System currently invests **65%** of its assets in common stock and **35%** in fixed income. Investments are further diversified within asset classes such as growth and value, large-, mid- and small-cap stocks, and varying maturity dates for fixed income holdings. The System's return on investments has compared favorably to both public and private pension plans across the nation.

The Task Force reviewed the TRS plan design. TRS is a defined benefit plan, which means benefits are determined by a formula based on total service and an average of final salaries. The current benefit formula is 2% times Final Average Salary times total service. Several meetings were devoted to examining proposals to freeze the current program and switch to a defined contribution plan. In a defined contribution plan, the employee and/ or employer contribute a specific amount, and these contributions are invested. The employee's benefit is based on accumulated deposits at the time the employee terminates employment. Defined contribution plans are more common in the private sector. The Task Force report recommends retaining the current defined benefit plan, noting, "The Task Force was unable to find a mechanism to make the transition from defined benefit plan to defined contribution plan even if it had been philosophically agreed that a defined contribution plan would be the best solution."

COLAs, or cost-of-living adjustments, were also a major topic of discussion among Task Force members. While the Task Force recognized the need for periodic COLAs, they unanimously agreed that no COLAs should be provided from OTRS assets without appropriate funding. Consequently, they recommended any COLA should not endanger the recommended amortization of current unfunded liabilities, nor should it reduce the recommended funding target level. The Task Force believes ad hoc payments or COLAs

(continued on p. 3)

Task Force report recommends solutions for TRS fiscal crisis

(from p. 2)

should be funded by direct appropriations from the Legislature. The report includes a recommendation to create a COLA Trust Fund into which the Legislature could make appropriations.

The Task Force also recommends the Legislature annually review the need for COLAs. One minority report signed by 14 Task Force members calls for increasing employer contributions by 0.95% to pre-fund COLAs. A minority report by five members recommends using a portion of "excess earnings" to fund COLAs. "Excess earnings" is defined as investment earnings in excess of the expected return included in actuarial assumptions. The current expected earnings rate for TRS is 8%, which is the highest rate for any Oklahoma public pension plan and slightly above the national average for public plans. The majority of Task Force members do not recommend using "excess earnings" stating that this practice could seriously damage the financial soundness of the System.

The Task Force report cites statistics to show many retirees have not experienced a loss in purchasing power. The report says benefits for a majority of members who retired prior to 1982 have actually increased at a rate higher than inflation providing them with greater purchasing power than they had when they retired.

The Task Force recommends no changes in the current vesting policy requiring a member to work at least ten years before he or she is eligible to retire. Also, the Task Force recommends retaining mandatory membership for higher education employees. The report notes that lowering employer contribution rates would make more affordable the current dual system of pension benefits available to higher education members. Non-classified optional school employees would still be able to join TRS, but not required to do so. The report recommends researching effective ways to encourage TRS members to retire later, reversing the trend toward earlier retirements.

The report includes eight appendices of supplemental information. One appendix contains five minority reports on various issues: one recommending maintaining or accelerating the current funding schedule instead of lengthening the program as recommended by the majority, two concerning COLAs, one covering a range of issues including transition to a defined contribution plan, and one supporting a change to a five-year vesting plan.

1998 TRS Legislative Recommendations

These recommendations were adopted by the Board of Trustees in January 1998.

General Goals:

Maintain the funding schedule as provided in 70 O.S.§ 17-108.1 (Enrolled Senate Bill 568, enacted in 1992).

Ask the Legislature to explore options that are available to provide funding to local employers to fully implement the financial provisions of 70 O.S. § 17-108.1.

Fund any benefit increase improvements over a period consistent with standard actuarial assumption.

The statutory funding schedule (Title 70 O.S. § 17-108.1) sets minimum annual contribution levels the State and local school districts must remit to the Teachers' Retirement System in the form of "employer contributions." Local schools are required to make up the difference between the total annual employer's contribution, stated as a percentage of employees' pay, and revenue received from the tax on natural gas. Base on current actuarial projections the Teachers' Retirement System will need annual increases in employers contributions of $33 to $59 million during the next eight years and additional increases between $25 million and $37 million during the period from 2006 and 2017.

Specific Recommendations:

Earmark that portion of the severance tax on natural gas currently allocated to the State's General Revenue Fund to the Teachers' Retirement System. The Teachers' Retirement System currently receives 78%of the original severance tax (5% of the price per 1000 cfm). The total tax on production of natural gas is 7% of the price at the wellhead.

Earmark a percentage of growth revenue available to the General Revenue Fund to the Teachers' Retirement System.

Dedicate a percentage of available funds in the State's Rainy Day Account to be appropriated to the Teachers' Retirement System.

TEACHERS' RETIREMENT SYSTEM OF OKLAHOMA
STATEMENTS OF PLAN NET ASSETS
JUNE 30,1997 AND 1996

Assets	1997	1996
Cash	$ 4,849,032	$ 3,713,877
Short-term investments	220,108,437	128,163,454
Long-term investments	4,068,686,826	3,414,147,566
Security lending institutional daily assets fund	341,361,543	234,350,169
Accrued interest and dividends receivable(1)	25,390,457	28,337,074
Contribution receivable	25,224,624	--
Receivable from State of Oklahoma(2)	9,863,177	11,128,546
Due from brokers for securities sold(3)	1,376,842	24,492,330
Land, furniture and fixtures, net	314.233	244.5 17
Total assets	$4,697,175,171	$3,844,577,533
Liabilities and Reserved Funds		
Benefits in process of payment	$ 15,539,978	$ 15,229,420
Due to brokers for securities purchased(')	30,630,632	33,485,254
Payable under security lending agreement	341,361,543	234,350,169
Compensated absences	127.803	115,568
Total liabilities	$387,659,956	$283,180,411
Net assets held in trust for pension benefits and annuity benefits of electing members	$4,309,515,215	$3.561.397.122

***Statements of Plan Net Assets* Explanation**

(1) Earned but not yet received
(2) Dedicated revenue from natural gas tax received in July
(3) Pending transactions of purchases, sales committed to but not yet settled

Statements of Changes in Plan Net Assets
Years Ended June 30,1997 and 1996

	1997	1996
Additions:		
Contributions:		
Members	$ 173,003,479	$ 149,884,939
Employer(4)	114,626,865	55,111,484
State of Oklahoma and various federal sources(5)	162,115,124	122,083,443
Total contributions	449,745,468	327,079,866
Investment income:		
Interest	107,430,221	103,029,538
Dividends	47,881,173	44,728,837
Net appreciation in fair value of investments(6)	588,476,445	320,480,844
Less investment expenses	(7.589.806)	(6,816,327)
Net investment income	736,198.033	461,422,892
Other revenue	197,238	84,740
Total additions	1.186,140,739	788,587,498
Deductions:		
Retirement, death, survivor, and health benefits	418,015,034	396,147,031
Refund of member contributions and annuity payments	34,633,635	31,814,168
Administrative expenses	2.401.727	2,214,437
Total deductions	455,050,396	430,175,636
Net increase	731,090,343	358,411,862
Net assets held in trust for pension benefits:		
Beginning of year	3,561,397,122	3,202,985,260
Cumulative effect of a change in an accounting policy	17,027,750	--
End of year	$4,309,515,215	$3,561,397,122

***Statements of Changes in Plan Net Assets* Explanations**

(4) Employer contributions made directly to TRS
(5) Contributions from employers to match the contributions of employees who are paid from federal funds and money from the state's tax on natural and casinghead gas
(6) Unrealized appreciation and realized investment gains/(losses) from the sale of securities

Governor hopes TRS fiscal problems resolved soon

Governor Keating: Resolution of TRS fiscal problems "a *moral* obligation"

Acknowledging the Teachers' Retirement System's fiscal problems is a prerequisite to fixing them, Gov. Frank Keating told **TRS** trustees in December.

"Legislative leadership will address (the TRS fiscal problems) with good will. It's an important moral obligation for us," Gov. Keating said.

Among the System's financial problems acknowledged by the Governor was an unfunded liability of **$4.7** billion, which means the System has promised to pay that much more in benefits than is currently available.

Options to resolve the System's fiscal problems could include changing the System from a defined benefit plan to a defined contribution plan, the Governor said. Under the current defined benefit plan, a member's retirement is "defined" (or determined) based upon a formula including the member's final average salary and number of years of TRS membership.

In a defined contribution plan, contributions and investment earnings on those contributions accumulate to produce an account balance for each participant. The participant's retirement benefit is based upon the accumulated value of the contributions and investment earnings. Participants are entitled to the "vested" portion of their account balances when they retire or terminate employment. The private sector 401k is an example of a defined contribution plan.

Gov. Frank Keating and TRS Trustees
Front row: Bob Gates, George Barnes, Gov. Keating, Dr. Wayne Bland, Susan Raasch, Celeste Tillery; back row: Tom Daxon, Ron Wallace, Barbara Osbom, Tommy Fulton. Greg Weaver, John Kahre. Not pictured: Sandy Garrett and Helen Snyder-Rambo.

"Retiring teachers, who are obviously highly educated, are smart enough to determine the truth (about TRS's financial picture)," Gov. Keating said.

The Teachers' Retirement System's funding problems affect more than the System and its members, he said.

"The TRS unfunded liabilities situation affects drawing new business to Oklahoma," he said.

The Governor called for a solution to be proposed soon.

"I would hope we'd have a solution within the next year-and-a-half, certainly proposed by January," Gov. Keating said. He urged TRS trustees to use the task force's recommendations as a starting point to approach individual legislators with ideas to resolve the System's funding problems.

"They (legislative leadership) don't want to panic (TRS members)," he said.

TRS retirees last received a cost-of-living increase in **1994.** That increase averaged **2%%,** based upon the retiree's final average salary and number of years membership before retirement.

TRS investment earnings top list

TRS posted a **22.4%** return on its investments for the year ending Dec. **31, 1997.** The return was the highest for the seven state pension funds monitored by the Oklahoma State Pension Commission.

A recent report to the Commission shows TRS's return on equities at **36.4%** for the period, while fixed income earned a **9.1%** return. TRS had **65%** of its assets invested in equities, **32%** in fixed income and **3%** in cash equivalents.

Annualized return for the 5-year period was **13.8%** versus **13.1%** for the median public fund in the R.V. Kuhns & Associates universe of **95** similar pension plans.

TRS imaging project entering final stages

TRS's most recent project to better serve members will give the Retirement System's staff quicker access to files, and will protect against misplaced or damaged documents.

More than 3 million paper documents have been scanned and written to permanent optical disk. The project's next phase includes examining workflow patterns to ensure applications for enrollments, retirements and withdrawals are processed as efficiently as possible.

Legislators contemplate Teachers' Retirement System legislation

About a dozen bills directly related to the Teachers' Retirement System, including one that could lead to a cost-of-living adjustment for TRS retirees, remained active when this issue of Trends went to press.

The surviving bills were culled from among some 50 TRS-related measures greeting lawmakers when the legislative session began in February. The session adjourns May 29.

Several TRS-related measures were filed as "shell bills,'' which are measures containing only superficial changes, and to which provisions are added during the session.

Bills must survive several legislative deadlines to become law. The first deadline of the 1998 legislative session, Feb. 19, was the last chance for measures to be reported from committee in their house of origin. The deadline for the third reading of measures in their house of origin was March 12. Legislation passing muster in its house of origin went to the opposite house, where the deadline to report it out of committee was March 26. The deadline for the third reading in the opposite house was April 16. If measures that have survived to that point are approved, they are sent to the Governor for his signature. The Governor will either sign the measure into law, or veto it.

State law requires the Legislature to adjourn by 5 p.m. the last Friday in May.

1998 TRS Legislation

House Bill 1094	***Shell bill***
House Bill 2288	*Benefit Enhancement Account for Retirees Act (BEAR); **shell bill**.*
House Bill 2500	*Exempts $5,000 death benefit from state income tax.*
House Bill 2568	*Allows child support that is part of a qualified domestic order to be paid from retirement benefits.*
House Bill 2668	***Shell bill***
House Bill 2695	*Enacts the Cost-of-Living Adjustment Feasibility Analysis Act, but contains no specific provisions.*
House Joint Resolution 1034	*Calls for a vote of the people to apportion part of state's growth revenue to TRS.*
House Joint Resolution 1066	*Calls for a vote of the people to authorize alternate funding of TRS through bond proceeds.*
Senate Bill 776	*Continues provisions of House Bill 1873 from 1997 session, providing state credit toward teachers' retirement contribution amounts.*
Senate Bill 1033	*Appropriates $50 million to TRS from state's Rainy Day Fund through increasing percentages of state's gas tax revenue.*
Senate Bill 1037	*Requires study of TRS's financial situation in relation to COLAs for TRS retirees.*

***Trends** is published and issued by the Oklahoma Teachers' Retirement System as authorized by TRS Executive Secretary Tommy C. Beavers. 120,000 copies have been printed by the Department of Central Services Central Printing Division at a cost of $7,564.70. Copies have been deposited with the Publications Clearinghouse of the Oklahoma Department of Libraries.*

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