

# **TMRS Fund Restructuring**



## **Questions and Answers**

**Texas Municipal Retirement System  
2011**

Copyright 2011, Texas Municipal Retirement System

This brochure is an informal presentation of information about TMRS and related issues. If any specific questions of fact or law should arise, the statutes will govern.

TMRS and the TMRS logo are registered trademarks of the Texas Municipal Retirement System.

# **Fund Restructuring Questions and Answers**

HB 997 by Truitt and SB 350 by Williams contain the TMRS Board of Trustees' recommendation for restructuring TMRS funds — the internal accounts that hold employee and city contributions and that pay retirement benefits. Restructuring TMRS' internal accounts will provide more efficient funding, reduce year-to-year volatility in city contribution rates, and result in lower contribution rates and improved funded ratios for most cities without reducing member or retiree benefits.

The recommendation for restructuring was made with the advice of the system's consulting actuary, Gabriel, Roeder, Smith & Company (GRS), and with the unanimous recommendation of the TMRS Advisory Committee on Retirement Matters, a group composed of 19 members representing cities, employees, elected officials, and retirees.

This booklet is intended to help cities, members, retirees, and elected officials better understand the proposal.

## **The Benefits of Restructuring**

- Contribution rates for most cities will be lower.
- Current benefit levels may be more sustainable for cities.
- By completely eliminating the leveraging impact of the current structure, the combined fund is protected from the downside risk of large, leveraged negative total returns, and the return volatility is reduced to the level of a typical pension trust fund.
- Contribution rates are likely to be more stable from year to year.
- Target reserve level can be reduced from 20% of assets to a much lower level.
- Actuarial funded ratios (a common measure of retirement plan soundness) for most cities will be improved.

# Effects of Restructuring

## Q. How does restructuring decrease required city contribution rates?

- A. For most cities, the annual required contribution will be reduced, since the city would receive interest on a larger base of assets over a longer period of time. The vast majority of defined benefit plans are funded under a similar structure.

Under the current structure, when a member retires, city assets are transferred from the Municipality Accumulation Fund (MAF) to the Current Service Annuity Reserve Fund (CSARF). (For details, see “The Current Structure” section starting on page 3.) Those city funds then receive annual interest at a rate of 5%. Under a restructured fund, at the time of retirement, money would not be transferred to the CSARF (it would stay in the combined/single Benefit Accumulation Fund (BAF) account of each city). By reallocating the CSARF assets and liabilities and the Employees Saving Fund (ESF) assets into each city’s combined BAF account, all future investment earnings based on that city’s contributions for active and retired members would be applied directly to that specific city’s trust assets and included in the funding equation, resulting in decreased liabilities and contribution rates. (See Cash Flow illustrations on page 6.)

## Q. How does restructuring reduce future volatility in city contribution rates?

- A. “Folding” the CSARF and ESF into the MAF to create the new BAF completely eliminates “leveraging,” reduces the investment return volatility to that of a typical pension fund, and thereby creates an environment for rate stabilization. Rates may still vary somewhat from year to year, and investment returns similar to 2008 would still reduce funding levels, but between restructuring and the asset smoothing mechanisms already in place, the effect of poor investment performance would be mitigated.

## Q. How does restructuring improve city funded ratios?

- A. A pension plan’s funded ratio is the ratio of actuarial assets to liabilities. Under the current structure, the ESF balance is added to both the numerator (employer MAF balance) and denominator

(employer accrued liability) in determining the employer's funded ratio. Assets and liabilities that have already been transferred to the CSARF are not included in the calculation. Under restructuring, all city assets and liabilities would be included in that city's funded ratio.

### **Q. What happens if restructuring is not accomplished?**

- A.** All the advantages of fund restructuring — eliminating leveraging, normalizing the volatility of returns, reducing contribution requirements for most cities without adversely affecting actuarial condition, lowering TMRS reserve requirements, decreasing cash flow pressure on mature plans, and stabilizing city contribution rates — would not occur. TMRS would need to continue to build a large reserve.

### **Q. How much will restructuring decrease my city's contribution rate?**

- A.** TMRS sent letters to most cities in early August 2010 showing estimated rate reductions associated with restructuring. Many cities would see a reduction in the neighborhood of 2 percentage points (200 basis points), although some changes would be higher and some lower.

It is important to note that the estimates GRS has prepared were based on the December 31, 2009, actuarial valuation and the current reserve level of 4% of the fund. The actual amounts of city rate reductions will depend in part on actuarial experience and investment performance at the end of 2010.

## **The Current Structure**

### **Q. How are TMRS funds structured today?**

- A.** Under TMRS' current structure, most assets are held in trust in three distinct accounts, called "funds" (see the TMRS Cash Flow illustration on page 6). The Municipality Accumulation Fund (MAF) holds city contributions and interest. The Employees Saving Fund (ESF) holds member contributions and interest. When a member retires, the accumulated contributions and interest in the member's account transfer from the ESF, along with matching funds from the city's MAF, into the Current Service Annuity Reserve Fund (CSARF). The basic current service retirement benefit is therefore

fully funded at the time of a member's retirement and is then paid monthly to the retiree from the CSARF. Additional prior service benefits, if any, including Updated Service Credits (USC) and Annuity Increases (COLAs) are paid from the MAF of the city that adopted the benefit provisions.

All assets of the entire TMRS Pension Trust are invested as a whole, and the transfers between accounts are accounting, or "paper," transfers only. It is important to note that there is no liquidation and reinvestment of assets associated with these transfers at retirement.

## **Q. How are annual investment earnings allocated?**

**A.** By law, the ESF and CSARF are credited with 5% annual interest. For purposes of projecting funding costs, the annual interest credit to the MAF is assumed to be 7.5%, but the actual interest credit will vary from year to year, as determined by the Board, depending on investment returns. The TMRS actuarial annual investment return assumption for the entire fund is 7%. In some years the return may be higher than 7%, while in other years, it may be lower, and the crediting rate will vary accordingly.

## **Q. What happens if the actual investment return is higher or lower than 7%?**

**A.** In years when the System as a whole earns more than 7%, the potential crediting rate to the MAF may be significantly higher than the assumed crediting rate of 7.5%. Under current Board guidelines, any interest above 7.5% goes into the System's reserve. At current fund levels, an annual investment return of approximately 6% will provide 5% to the ESF and CSARF and 7.5% to the MAF, with nothing "left over" for the reserve. If the annual investment return differs from 6%, the effect on the MAF becomes magnified, or leveraged. For example, if the total portfolio return is -1%, the leveraging impact on the MAF results in a crediting rate to the MAF of approximately -11%. Similarly, if the total portfolio return is +7%, the resulting potential MAF crediting rate is approximately +10%.

In a year like 2008, when investment markets were sharply down, the negative effect on the MAF could be severe. For many TMRS cities, the CSARF is growing faster than the MAF, so the potential impact of returns below 7% will be even greater in the future.

**Q. How does the current structure create the potential for year-to-year contribution rate volatility for cities?**

- A.** City contribution rates to fund retirement benefits are calculated each year by the TMRS consulting actuary. One of the key elements in the calculation is the amount of interest credited from annual investment earnings. In simple terms, deviations in the actual MAF interest credit above or below the assumed 7.5% are reflected in each city's actuarial experience for the year in determining the city's required contribution rate. Consequently, the volatility of highly leveraged MAF interest credits (discussed in the previous question) will be reflected in the city contribution rates. TMRS has taken a number of steps to help mitigate contribution rate volatility — including asset smoothing and the establishment of a reserve policy — but the current fund structure allows for potentially severe annual swings in MAF returns and rates.

**Q. Why have TMRS' funds been structured this way historically?**

- A.** The three-part fund structure was established when the System was created under state law in 1947. The CSARF helped protect very small pools of retirees from "longevity risk," the chance that benefits would be depleted if a few retirees lived longer than their assumed lifetimes. As the pool of retirees has grown, the likelihood of actuarial losses arising from this factor is much smaller than when the System was established. (See page 8 for information on small cities after restructuring.)

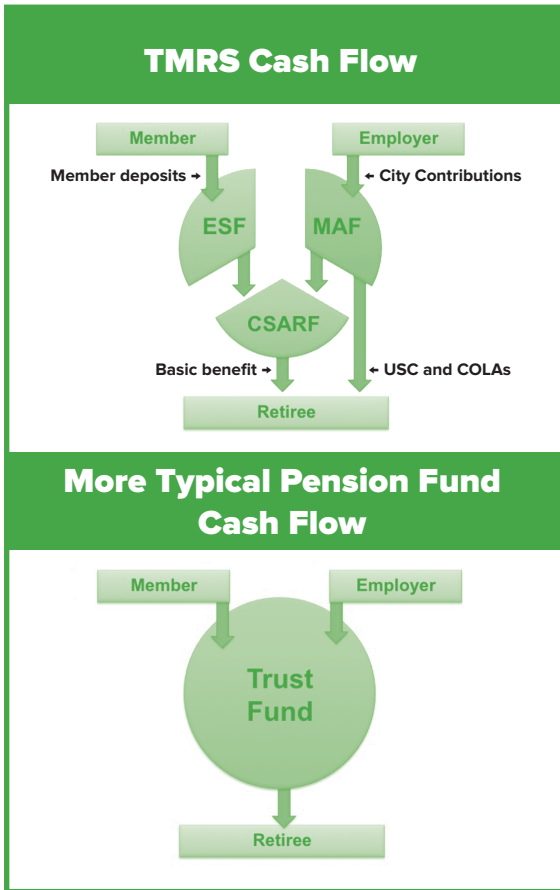
## **The Proposed Structure**

**Q. What would TMRS funds look like after restructuring?**

- A.** In the fund restructuring legislation recommended by the Board, the MAF, CSARF, and ESF would be combined and accounted for as a single fund called the Benefit Accumulation Fund (as depicted in the More Typical Pension Fund Cash Flow illustration, page 6).

The CSARF assets and liabilities associated with each city's retirees, as well as the ESF assets associated with each city's employees, would be distributed back to the cities and held in trust in their new Benefit Accumulation Fund (BAF) account. Future member and city contributions would be deposited directly in the BAF, and all

benefits would be paid from there. This is a structure similar to nearly every other contributory defined benefit retirement fund in the country.



**Q. How would annual investment earnings be allocated after restructuring?**

- A.** Individual employee accounts would still be credited 5%, just as they are today. If investment returns permit, each city’s BAF account would receive the actuarially assumed 7% investment return. If restructuring legislation passes, it is likely that the TMRS actuaries will recommend that the System continue to maintain a reserve fund so that amounts can be withdrawn from reserves in “down” years to meet the assumed 7% BAF crediting rate and help stabilize contribution rates; however, the reserve guideline is likely to be much lower than the current initial guideline of 20% of total trust assets.

## Member and Retiree Issues

### **Q. Would restructuring affect my benefit, as either an active member or a retiree?**

**A.** Restructuring would not directly affect any benefits of active members, retirees, or beneficiaries. It would only affect the internal accounting of TMRS funds. Reducing the contribution requirements for cities may make current benefit levels more sustainable.

### **Q. Would active employees' accrued benefits be as well protected after restructuring as they are today?**

**A.** Yes. There would be no change in the protections currently afforded active employees. The TMRS fund would still be a trust fund reserved for the benefit of members and retirees. The money that a member contributes to his or her retirement account is protected by state law — it may not be used for any purpose other than to fund the member's retirement (or to be refunded if the member leaves service without retiring).

### **Q. Would retirees' benefits be as well protected after restructuring as they are today?**

**A.** Yes. Retiree benefits would still be protected by state law. Currently, the basic retirement benefit is "fully funded" in the CSARF, but benefits associated with Updated Service Credit and COLAs are paid from each city's MAF. If restructuring passes, all benefits would be paid from the Benefit Accumulation Fund (BAF), and cities would have the statutory responsibility to fund them through contributions.

Because the benefit payment cash flows of the entire Pension Trust Fund are identical under the current and proposed fund structures and because cities cannot access money held in the current MAF nor in the proposed BAF, retiree benefits are at least as secure under the proposed restructuring legislation as under the current structure.

## Small Cities

### Q. Would small cities be handled any differently than large cities after restructuring?

- A. TMRS' consulting actuary, GRS, is currently studying the funding mechanism for small cities in a restructured environment and will make recommendations to the Board. Generally, very small cities in TMRS are more conservatively funded due to the volatility that can result from a very small group of covered individuals, so the effect of restructuring on small cities may be less pronounced. It is likely that small cities will continue to operate under more conservative actuarial assumptions to ensure that they are protected from experience risks.

## Other Issues

### Q. Would restructuring affect the way TMRS invests money?

- A. Restructuring would not affect TMRS' current investment strategy or the ongoing diversification of the TMRS investment portfolio.

### Q. Why is legislation necessary?

- A. It is not possible to combine the three TMRS funds into one fund without amending the TMRS Act. Cities need protection from the current structure's risk of large leveraged negative investment returns to the MAF in poor investment markets such as 2008. A beneficial "by-product" of restructuring is reduced city contribution rates and improved funded ratios.

# For More Information

## Legislative Issues

**Dan Wattles**

*dwattles@tmrs.com*

Fax • 512.474.9180

## City Rate and Actuarial Issues

**Eric Davis**

*edavis@tmrs.com*

**Leslee Hardy**

*lhardy@tmrs.com*

## General Questions

**Phone Center**

Toll-free • 800.924.8677

Local (in greater Austin) • 512.476.7577

**Website**

*www.tmrs.com*

**E-mail**

*phonecenter@tmrs.com*

**TMRS Headquarters Building**

1200 North Interstate 35

Austin, TX 78701

**Mailing Address**

P.O. Box 149153

Austin, TX 78714-9153



**Texas Municipal Retirement System**