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Review of the Annual Funding Status of Local Government Defined Benefit Pension Plans External to Tennessee Consolidated Retirement System (TCRS)

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Executive Summary

At the request of the Legislative Council on Pensions and Insurance, in April, 2013 the Director of the Tennessee Consolidated Retirement System (TCRS) requested actuarial and financial information from local governmental entities with defined benefit pension plans external to TCRS.

The TCRS includes 487 local government entities, plus 118 local education agencies whose K-12 public school teachers are members of the TCRS. Under current state law, all of these entities are required to pay 100% of the annual required contribution (ARC) as actuarially determined each year. The Commissioner of Finance and Administration is authorized to intercept state shared taxes to pay the ARC if an entity fails to do so.

The survey found 31 local government pension plans external to TCRS, 13 of which did not pay 100% of the ARC in 2012, see chart in section titled *"Local Government Entities with Defined Benefit Plans External to TCRS"*, at pages 5-7. Conversely, a majority of the defined benefit pension plans external to the TCRS, i.e. 18 of 31 plans, fully funded the ARC. Thus, only 2.04% of all Tennessee local government pension plan entities fund less than 100% of the ARC. This evidences a clear governmental policy in Tennessee that entities should pay 100% of the ARC each year. In contrast, the annual amount of underfunding represented by those entities paying less than the ARC is a significant annual amount - at least $86.4 million in 2012. The market value of the total unfunded liabilities of plans underfunding the ARC is $1.5 Billion.

The Governmental Accounting Standards Board in 2012 acted to abolish the concept of the ARC, and effective for fiscal years beginning after June 15, 2014, no longer requires governmental employers to report an actuarially determined annual required contribution in their financial reports. The new GASB standards will no longer set the parameters within which an employer's ARC must be calculated. The Government Finance Officers Association (GFOA) and other professional finance organizations have adopted positions calling for governments to adopt a funding policy based on an actuarially determined annual funding amount.

Thus, the TCRS and also each Tennessee local government with a defined benefit pension plan should adopt a written pension funding policy based on an actuarially determined annual contribution. The general policy objectives for funding a pension plan should include practicing funding discipline, maintaining intergenerational equity, managing contributions as a stable percentage of payroll, and ensuring accountability and transparency. The GASB also required inclusion of a liability entry in financial statements for the net pension liability. For governments who underfund the annual contribution, a blended discount rate must be used to determine net pension liability, resulting in a significantly higher liability entry and pension expense.

In view of Tennessee's strong public policy of payment of 100% of the ARC each year, the potential adverse consequences to governmental workers who depend on these plans for economic security in retirement and to the affected local government units, the Treasury Department recommends that legislation be enacted which requires local government entities with defined benefit pension plans external to the TCRS to fund annually 100% of an actuarially determined contribution, subject to a 5 year incremental phase-in period. Since the recommended phase-in period begins in fiscal year 2015-2016, it is effectively a 6 year phase-in period. Further, public pension plans external to TCRS should be subject to the same procedure to enforce payment of the ARC as currently applies to TCRS local government pension plans.

The Treasury Department further recommends that legislation be enacted requiring a written funding policy be adopted which includes use of six (6) key widely utilized parameters in the determination of annual public pension plan funding, see section titled *"Public policy relative to funding pension obligations- Recommendations", at pages* 11-12. Since there are numerous additional key parameters which are decided by the actuary and the local governments that are utilized in pension plan accounting that influence the calculation of the ARC and funding levels, the inclusion of 6 parameters in the required funding policy represents a minimal approach to this issue.

Accordingly, Senate Bill 2079 House Bill 2037 have been introduced and will be heard by the Legislative Council on Pensions and Insurance on Monday, February 3, 2014, at 1:00 PM CST in Legislative Plaza Hearing Room LP 29, when a presentation will be made by the Tennessee Treasury Department. These proceedings will be webcast and may be viewed at http://wapp.capitol.tn.gov/apps/livevideo/, and will be archived for subsequent viewing. Questions or comments prior to the hearing should be directed to Rick DuBray, CPA, Second Deputy Treasurer, at Rick.DuBray@tn.gov or 741-9962. The address of the Treasurer's office is: 600 Charlotte Avenue, State Capitol, First Floor, Nashville, Tennessee 37243.

Introduction

For those defined benefit plans operated by local governmental entities external to the Tennessee Consolidated Retirement System (TCRS), TCA § 3-9-203 provides that upon the request of the Council on Pensions and Insurance, the chief executive officer or plan administrator shall file with the Council the latest actuarial and financial data of the retirement plan.

At the request of the Legislative Council on Pensions and Insurance, in April, 2013 the Director of TCRS in the Tennessee Treasury Department began requesting actuarial and financial information from those governmental entities that have a defined benefit pension plan external to TCRS. As used in this report the term local government entity pension plan includes entities such as boards, commissions or instrumentalities such as sewer districts, utility districts, special school districts and other miscellaneous entities.

This report was prepared to provide the Council with a brief overview of selected actuarial information about local government and pension plans external to TCRS. The report begins with brief review of local government pension plans in the TCRS. The information in this report addresses the following topics:

- General pension information for local governments in TCRS
- Summary pension information with analysis regarding the actuarial status of local government pension plans that are external to TCRS
- Impact of newly issued pension accounting standards by the Governmental Accounting Standards Board (GASB)
- Potential future GASB pronouncements related to other post-employment employee benefits (OPEB)

- Potential impact of pension liability on bond ratings by rating agencies
- Discussion about the challenging investment market place that institutional investors now face
- Objective of funding pension obligations annually
- The cost of delaying pension funding
- Public policy relative to funding pension obligations- Recommendations
- Outline summary of proposed legislation, Senate Bill 2079 House Bill 2037

This report does not include review or analysis of investment policy, investment strategy, investment performance, or investment expense or cost of administration relating to the operation and management of local government pension plans. This report also does not include any review of the work performed on behalf of local government pension plans by any general investment consultants or specialized investment consultants.

Overview of local governments in the Tennessee Consolidated Retirement System (TCRS)

The TCRS is a defined benefit plan with approximately 212,000 active employee members and 116,000 retirees comprised of four large groups of public employees. The aggregate retirement benefits paid annually by TCRS are approximately $2 Billion. The groups are K-12 public school teachers, state employees, higher education employees, and local government employees. Participation in TCRS by local governments is voluntary. The chief legislative body of a local government or other participating local government entity must pass a resolution to participate in TCRS. The resolution provides the terms of participation (prior service, COLA, formula, etc.). The resolution also provides that the local government is financially responsible for the pension cost, including administrative cost and investment cost, associated with their employees and retirees.

The cost and liability is not shared with any other governmental entity including the state. For retirees of each participating local government entity, benefits are paid only to the extent of funds credited to that local government entity, i.e. neither the state nor any other local government has liability for the payment of retirement benefits on behalf of a particular local government entity. Prior to the local government requesting participation in TCRS, an actuarial valuation is performed to determine the actuarially required employer contribution rate under the various options that the local government is considering. When a local government requests to participate in TCRS, the final step of the process is the approval of the TCRS Board of Trustees.

Separate accounting and actuarial records are maintained for each governmental entity in TCRS. A separate actuarial valuation is performed for each local government. The purpose of the actuarial valuation is twofold. One purpose is to determine an annual required contribution (ARC) to be paid by the employer and to determine the funded status of their plan. The second purpose is to calculate the accounting information for inclusion in the financial statements of local governments.

Under the law governing the participation of local governments in TCRS, if a local government does not pay its annual ARC payment, the Commissioner of Finance and Administration has the right to intercept any state-shared taxes that are otherwise apportioned to the local government. These intercepted funds are utilized to pay the required ARC payment. See TCA § 8-37-505.

Current Tennessee law requires annual payment of the ARC for state employees, inclusion in the budget by the Department of Education and appropriation by the General Assembly of the state portion of funding for the Basic Education Program allotted for contributions to the retirement system for the benefit of teachers. Further, the law provides that local education agencies shall provide for any increased amounts necessary to fully fund employer retirement contributions relative to teachers. See, TCA §§ 8-37-401 and 8-37-402.

The assets of TCRS are commingled for investment purposes. Each participating employer receives a pro rata share of investment income (losses). Each participating employer pays a pro rata share of the administrative cost and investment expense of the TCRS plan. For an analysis of the pension administration and investment expenses of southeastern states, See *Attachment 1.*

A list of the of political subdivision entities participating in TCRS as of June 30, 2013 is provided in the 2013 Annual TCRS Report on pages 97-100 found at http://treasury.tn.gov/TCRSAnnualReport2013.pdf. The chart below provides a summary of political subdivisions in TCRS.

Summary of Political Subdivision Entities participating in TCRS

Cities	177
Counties	88
Utility Districts	68
Special School Districts	19
Joint Ventures	21
Housing Authorities	11
911 ECD	47
Miscellaneous	56
Total	487

In addition to the entities above, the Kindergarten through Grade 12 public school teachers in the 118 Local Education Agencies (LEAs) that are not special school districts participate in TCRS. LEAs are in the aggregate considered a single cost-sharing pension plan pursuant to the accounting standards of the Government Accounting Standards Board (GASB).

Local Government Entities with Defined Benefit Plans External to TCRS

A local government may choose to establish a defined benefit plan external to TCRS. The local government is responsible for the plan document, plan design and policies, plan amendments, pension operations, investing activities, legal compliance, actuarial calculations, financial reporting, etc. The government may use external resources for many of these functions.

The governmental entities which have reported to the Treasury Department that they provide a defined benefit pension plan external to TCRS on behalf of their employees are shown in the chart below. These plans are ranked based on the funded percentage of the ARC for the 2012 year.

	Plan*	2012 ARC	% ARC Funded in 2012	Unfunded Liability Market Value of Assets	Funded Status Market Value	Status O-Open C-Closed
1	Dyersburg City Schools -non teachers	119,709	0.0%	1,724,153	72.2%	O
2	Memphis	90,363,000	22.6%	562,254,603	78.7%	O
3	Dyersburg City	1,486,334	50.5%	14,215,667	22.0%	O
4	Metro Nashville Airport Authority	2,816,921	53.2%	17,332,376	60.6%	C
5	Lenoir City Utilities Board	1,445,876	64.9%	8,097,705	61.6%	O
6	Alcoa	1,194,134	72.1%	14,640,534	59.1%	C
7	Hallsdale Powell Utility District	802,570	86.2%	3,653,915	57.6%	O
8	Bartlett	3,446,116	89.0%	24,184,843	68.7%	O
9	Knox County General Employees	1,497,424	89.2%	25,022,452	67.4%	C
10	Nashville	127,228,484	90.5%	711,926,327	75.4%	O
11	Chattanooga General Employees	7,203,000	92.8%	54,721,145	80.8%	O
12	Murfreesboro	4,705,717	96.8%	15,209,386	87.2%	C
13	Columbia	1,970,146	96.9%	27,388,701	55.2%	C
14	Germantown	2,306,853	100.0%	16,750,254	76.4%	O
15	Knox County Board of Education	1,046,949	100.0%	14,184,802	82.1%	C
16	Knoxville Utilities	3,244,057	100.0%	10,373,085	94.7%	C
17	Maury Regional Medical Center	728,000	100.0%	5,602,694	88.0%	C
18	Memphis LGW	57,330,000	100.0%	255,440,491	81.1%	O
19	Nashville Electric Service	21,712,909	100.0%	142,858,944	71.6%	C
20	Shelby County	23,401,532	100.0%	272,023,977	78.7%	O
21	Smyma	226,738	100.0%	957,325	83.5%	C
22	Chattanooga Fire and Police	11,859,505	100.7%	196,661,022	51.8%	O
23	Knoxville	11,386,903	101.0%	218,386,900	67.0%	O
24	Franklin	4,276,055	102.3%	19,077,783	76.9%	O
25	Knox County Uniformed Officers	4,108,886	106.8%	24,189,490	83.5%	O
26	Dyersburg Electric	364,877	112.3%	2,767,464	66.8%	C
27	Murfreesboro Electric Department	797,797	116.8%	909,148	95.0%	C
28	Collierville	2,289,002	125.2%	9,887,681	77.6%	O
29	Lawrenceburg Utility Systems	405,761	132.3%	2,900,120	81.6%	O
30	Hamilton County	50,074	134.6%	(1,156,646)	215.8%	O
31	Elk River Public Utility District	191,835	156.0%	754,100	81.6%	C
	Total	390,009,239		2,672,951,458		

*In addition to pensions plans shown, Hamilton County reported its closed teachers plan with unfunded liabilities of $11, 017 and an ARC of $2,075 which is funded on an ad hoc basis. This data is statistically insignificant and not included in this chart.

It is likely this is not a complete list of governmental entities with defined benefit plans outside of TCRS. With the large number of various government entities (cities, counties, utilities districts, housing authorities, emergency communication districts, special school districts, joint ventures, and other miscellaneous creations), it is possible that an entity with a defined pension plan has not been identified. There is no registration requirement to be filed with the state for a local government with a defined benefit pension plan external to the TCRS.

The above data shows that a majority of the defined benefit pension plans external to the TCRS, i.e. 18 of 31 plans, fully fund the ARC. The annual amount of underfunding represented by those entities paying less than the ARC is a significant annual amount - at least $86.4 million annually in 2012. The market value unfunded liabilities of the 13 plans underfunding the ARC are almost $1.5 Billion. Thus, the 2012 level of ARC underfunding represents an aggregate 5.76% annual increase in the unfunded liabilities for these 13 plans each year from this one source alone. These 13 plans have an average funded ratio of 65%.

When the two local government entities with the largest ARC underfunding are excluded, i.e. Memphis and Metro Nashville, the aggregate ARC underfunding of the remaining 13 plans is approximately $4.4 million in 2012. The market value of the total unfunded liabilities of these plans, excluding Memphis and Metro Nashville, is $206 million.

The 18 plans that paid 100% of the ARC in 2012 paid an aggregate of $145.7 million in annual contributions in 2012. These 18 plans have an average funded percentage of 80%.

Governmental Accounting Standard Boards (GASB) Statements 25 and 27 (Superseded as to certain pension trusts)

Issued in 1994, GASB statement 27 provides information about the presentation of pension data in the employer's financial statement. GASB statement 25 provides information about the presentation of pension data in retirement plan's financial statement.

GASB statements 25 and 27 formerly provided a direct linkage between "pension funding" and "pension expense" within certain parameters. These two statements provided the foundation for the concept of the *Annual Required Contribution* (ARC), also often referred to as actuarially required contributions. Six different actuarial methodologies were permitted which an employer may utilize in calculating the ARC. There were several other parameters required to be utilized for calculating the ARC. An employer was required to report the percentage of the ARC that was contributed each fiscal year for the prior five year period.

GASB statements 25 and 27 did not require the employer to include the unfunded liability as a debt or liability in the employer's financial statement. However, a liability would be recorded for the portion of the ARC that was not paid.

Governmental Accounting Standard Boards (GASB) Statements 67 and 68

In June 2012, GASB statements 67 (pension plan financial statement) and 68 (employer financial statement) were finalized that superseded statements 25 and 27 as they relate to pensions that are provided through pension plans administered as trusts or equivalent arrangements. Pension plans must begin reporting under the new standards for fiscal years beginning after June 15, 2013. For all government pension plans, the fiscal year 2013-14 financial statements must be produced in accordance with the new GASB 67 statement. Employers must begin reporting information on their financial statements under the new standards for fiscal years beginning after June 15, 2014. In the case of the State of

Tennessee, all political subdivisions and all other governmental entities the employer's financial statements for the 2014-15 fiscal year must be presented in accordance with GASB 68.
Highlights of certain impacts of GASB Statements 67 and 68 are outlined below:

- Now, there will be a separation of "accounting for pension expense" from "pension funding". There will no longer be an ARC defined by GASB. Pension plans that have been using the ARC under parameters prescribed by GASB as their funding policy will now need to establish a pension funding policy. The result of these changes in accounting standards means the amount recorded as pension expense for a fiscal year will be different than how a pension plan is funded. There will probably be significant volatility from year to year in the amount recorded as pension expense under the new standards.
- The entry age normal actuarial methodology will be the only acceptable actuarial method for financial statement purposes.
- The plan must calculate "Net Pension Liability" (i.e., which strongly correlates to unfunded pension liabilities) based on market value of assets. Previously, it was permitted to use an asset smoothing method.
- Net Pension Liability will be recorded as a long term debt (liability) on the employer's financial statement. Previously, these liabilities were not an entry on the balance sheet but were depicted in the notes to the financial statement. There will probably be significant volatility in the amount of the unfunded liability that will be recorded in the financial statements from year to year. This will impact the net equity position in a governmental entity's financial statement.
- Additional actuarial cost will be incurred. Not only will the actuary have to make two calculations (one calculation for accounting purposes and one calculation for funding purposes), but the calculation for accounting expense and unfunded liabilities are much more complex.
- It should be noted that based on Tennessee's methodology for funding K-12 education, the current interpretation is that the unfunded liability represented by the net pension liability and pension expense for K-12 teachers will be allocated to the 137 Local Education Agencies (LEAs). The amounts will be allocated to each LEA based on their share (or percentage) of employer contributions versus the total share of employer contributions by all LEAs to TCRS. The primary government for the LEA will include such unfunded liability and pension expense in their financial statement.
- For governmental entities that adopt a funding methodology that does not provide for actuarial funding of their pension plan or where the annual employer contributions are less than the actuarially determined amount, a blended discount rate (i.e. a substantially lower discount rate) must be used in determining the liabilities of the pension plan. The blended rate would be a combination of a long-term rate and a short-term rate. A blended rate would substantially increase the unfunded liability to be included as a liability in the governmental entity's financial statements.

Other Post-Employment Benefits (OPEB), other than pensions

Other post-employment benefits generally describe benefits furnished to retirees at the expense of a governmental entity. OPEB benefits include retiree health insurance, the cost of which is generally principally paid by the governmental entity. GASB has announced an exposure draft of accounting for OPEB liabilities and expenses will be issued in 2014. Generally, OPEB liabilities are primarily driven by the cost of employer-provided retiree health insurance coverage. Past history would indicate that GASB might create the same accounting and reporting standards for OPEB as it did for defined benefit retirement obligations with the issuance of GASB statements 67 and 68. If so, unfunded OPEB liabilities would also be recorded as a debt, or liability, in the employer's financial statements. Today, this obligation is an off-balance sheet liability that is depicted in the notes to the financial statements. This is another obligation that will most likely in the near future impact the net equity position of a local government. Also, there would be an employee/retiree insurance expense recorded in the financial statements.

Impact of Defined Benefit Pension Plans on Bond Rating by Rating Agencies

The various bond rating agencies consider the pension obligations of a municipality when assigning a rating. In 2013 Fitch Ratings issued a report comparing the debt obligations, including pension debt, among the 50 states. Tennessee has the high distinction of having the lowest overall state general obligation debt and unfunded state pension liabilities as a percentage of personal income.

Moody's Investors Service has taken a more aggressive analysis of pension obligations. Their approach is to revise the GASB produced actuarial data and restate them based on market value of assets and a discount rate based on a high-grade long-term taxable bond index which is typically much less than the investment earnings assumption for governmental pension plans. The discount rate used in 2013 by Moody's was 5.47%. Accordingly, Moody's restatement of GASB reported average funded ratio for all state pension plans dropped from 74% to 48%.

Standard and Poor's issued a report in 2013 titled *A Bumpy Road Lies Ahead for U.S. Public Pension Funded Levels.* This report reviews the funding levels of pensions for the 50 states. The report states that that debt, pension liabilities, and other postemployment benefits are key metrics. State obligations (debts and liabilities) are one of five major factors that determine a rating by Standard and Poor's.

Challenging Investment Outlook

During the 1980's and 1990's double digit investment returns were commonplace. These returns were driven by higher interest rates and a well-performing stock market. The 21st century has not been as kind to institutional investors such as pension funds. Interest rates have fallen to historically low levels, diminished outlook for the coming years. The stock market also suffered two sharp declines this century. One was in 2001, and the second more severe drop was in the 2008 to 2009 period. At the low point of 2009, the U.S. stock and international stock markets lost 50% of their value. This had a huge negative impact on the funding status of pension funds. Pension funds typically have 50% to 80% of their assets in the stock market.

The challenges going forward for pension funds will include the impact of tapering of quantitative easing by the U.S. Federal Reserve, the prospect of slow growth in the United States and world economies, and rising interest rates, which many economic and financial experts expect to occur. While rising interest rates increase the yield on the purchases of new fixed income securities, there will, however, be a decrease in the market value of existing fixed income securities in the portfolio. Also, rising interest rates (as a single factor and disregarding any other factors) will likely have a negative effect on the stock market.

Objective of Funding Pension Obligations Annually

There are many worthwhile objectives for pre-funding pension benefit obligations. First, pre-funding promised benefits using an acceptable actuarial methodology and reasonable actuarial assumptions will equally allocate the cost of such benefits being accrued to each generation of taxpayers. The pension funding policy of a governmental entity should not push accrued pension cost onto future generations of taxpayers.

Second, pre-funding pension benefits in an actuarially appropriate manner better enables a governmental entity to deliver the benefits that have been promised. Employees that work a career or former employees that have already retired are relying on pension benefits as part of their financial and economic security when they are no longer able to engage in gainful employment. It would be a disservice to employees and retirees to promise a pension benefit that cannot be delivered.

Third, a cost efficient pension plan is in the best interest of taxpayers that finance such benefits and is better achieved through pre-funding accrued benefits. The vast majority of the financing of the cost of pension benefits will come from investment income. For example, since 1975 TCRS has received 64% of its revenue from investment income. This means that $64 of every $100 in retirement benefits paid is funded by investment income. If an entity does not pre-fund accrued benefits, it is forgoing investment income. This means that the employees and the taxpayers have to pay more for the benefit being promised.

Accordingly, it is of utmost importance that all Tennessee governmental entities calculate annual pension funding requirements based on an appropriate actuarial methodology. Further, it is critically important that annual funding requirements be paid in full in a timely manner.

The Cost of Delaying Pension Funding

Failure to pay annually when due the full actuarially required contribution is in effect underfunding the pension plan. The amount that is not funded increases the unfunded accrued liabilities of the plan. Further, the pension plan will not have the under-funded amount available to invest, thereby resulting in lost earnings opportunity.

The funding for a pension plan assumes that 100% of the ARC will be paid annually, and further assumes that those contributions will be invested to earn at least the assumed rate of return for the pension plan. Thus, the failure to pay 100% of the ARC can quickly lead to a serious underfunding of the pension plan. Chronic underfunding of the ARC will eventually make the pension plan financially unstable. Nationwide, multiple severely underfunded pension plans that are now financially unstable are examples of the failure to pay annual funding requirements.

Under GASB Statements 67 and 68, the governmental entity is required to include on its balance sheet a liability entry that reflects the net pension liability of the pension plan. The net pension liability correlates strongly to the unfunded accrued liabilities of the plan. When the ARC is funded at less than 100%, the unfunded portion will increase the unfunded accrued liabilities and also the net pension liabilities of the pension plan. This underfunding along with the requirement that a lower blended discount rate be used by pension plans that fail to fully fund the annual contribution will substantially increase the liability entry for net pension liability on the balance sheet of the governmental entity.

Delaying pension funding by underfunding the ARC will likely be very expensive to the local government entity. It costs an additional $435,000 to delay a one million dollar pension payment for five years assuming an earnings rate of 7.5%. This is a 43.6% increase in the amount to be paid. The pension cost more than doubles by delaying a payment by 10 years. A $1 million pension cost becomes $2.06 million if delayed 10 years. See *Attachment 2* that illustrates the cost of delaying employer pension contributions.

Public Policy Relative to Funding Pension Obligations- Recommendations

As this report reveals, the vast majority of Tennessee local government pension plans pay 100% of the Actuarially Required Contribution (ARC) to their defined benefit pension plan. Indeed, all of the 487 local government entities in TCRS plus the 118 Local Education agencies (local k-12 school systems) whose teachers participate in TCRS are required by state law to fully fund the ARC each year. Even a majority of the defined benefit pension plans external to the TCRS, i.e. 18of 31 plans, fully fund the ARC. In summary, only 2.04% of all Tennessee local government pension plan entities fund less than 100% of the ARC. These facts alone confirm that the clear governmental policy in Tennessee is for entities to pay 100% of the ARC. In contrast, the annual amount of underfunding represented by those entities paying less than the ARC is a significant annual amount - at least $86.4 million annually in 2012. The market value unfunded liabilities of these plans are almost $1.5 Billion. The 2012 level of ARC underfunding represents a 5.76% annual increase in the unfunded liabilities each year from this one source alone. Also, as discussed in this report, underfunding the ARC will result in significantly larger funding requirements in the future, and larger amounts of net pension liabilities included as a liability entry on the local government balance sheet.

Accordingly, the Tennessee Treasury Department recommends that legislation be enacted which requires local government entities with defined benefit pension plans external to the TCRS to fund annually 100% of the ARC, subject to a 5 year incremental phase-in period. Since the recommended phase-in period does not begin until fiscal year 2015-2016, it will effectively be a 6 year phase-in period. Further, public pension plans external to TCRS should be subject to the same procedure to enforce payment of the ARC as currently applies to TCRS local government pension plans.

GASB noted in its release accompanying Statement No. 68 that pension contribution issues are public policy matters. Indeed, leading finance professional organizations, including the Government Finance Officers Association have adopted positions calling for governments to adopt a funding policy based on an actuarially determined annual funding amount. The data gathered by the Tennessee Treasury Department clearly reflects that the overwhelming majority of pension plans have adopted reasonable positions as to key components in the determination of funding requirements. For example, only 5 of the 638 pension plans and LEA's have adopted open amortization of unfunded accrued liabilities, while the clear practice is to utilize the stronger closed amortization. Similarly, the overwhelming majority of pension plans have adopted assumed rates of return that are at 8% per annum or less. Only 1 plan of the 638 pension plans and LEA's utilize an assumed rate of return in excess of 8%. However, in view of Tennessee's clear public policy in favor of strong annual funding of public pension plans, these instances do emphasize the need to adopt several key baseline parameters in annual funding calculations.

The Treasury Department recommends that legislation be enacted which requires a written funding policy be adopted which includes use of six (6) key widely utilized parameters in the determination of annual public pension plan funding. These 6 parameters are:

a. Defines acceptable actuarial method, except that projected unit credit method is not permitted
b. Determination of the Actuarial value of assets is limited to maximum 10 year smoothing with a 20% corridor
c. Level dollar amortization must be used for unfunded liabilities by 2020
d. Mortality assumption should consider the effects of expected improvement by 2024
e. A closed maximum amortization period of 30 years will be utilized
f. Investment earnings assumption cannot be in excess of 50 basis points greater than that used by TCRS

Since there are numerous additional key parameters which are decided by the actuary and the local governments that are utilized in pension plan accounting that influence the calculation of the ARC and funding levels, the inclusion of 6 parameters in the required funding policy represents a minimal approach to this issue.

The Treasury Department also recommends other provisions that are applicable to both TCRS and Local Government Pension Plans that are external to TCRS. See the Outline Summary section below and also *Attachment 3* copy of Senate Bill 2079 and House Bill 2037 as introduced.

Outline Summary of Senate Bill 2079 House Bill 2037

The following is an outline summary of the proposed Public Employee Defined Benefit Financial Security Act of 2014:

Section 1 Relating to Tennessee Consolidated Retirement System

1. Requires development of a pension funding policy by the state treasurer to be adopted by the board of trustees
    a. Requires that the funding policy must include an actuarially determined contribution (ADC)
    b. Funding and Policy must establish a maximum amortization period for the unfunded accrued liabilities
    c. Provide for 100% funding annually of the ADC
    d. Funding policy must be submitted to Comptroller of the Treasury within 30 days of adoption or amendment
2. Requires that the actuarial methodology provide that projected revenues and current assets will finance the projected benefits calculated in accordance with Actuarial Standards of Practice by the Actuarial Standards Board

3. Certain minimum requirements for calculating the ADC
    a. Entry age normal method must be used
    b. Actuarial value of assets limited to a 10 year smoothing with a 20% corridor
    c. Level dollar amortization must be used for unfunded liabilities
    d. Mortality assumption must, by 2024 consider the effects of expected improvement
    e. A closed maximum amortization period of 30 years for unfunded liabilities

Section 2 Relating to Tennessee Consolidated Retirement System

1. Deletes previous actuarial requirements that are replaced in Section 1 of this bill

Section 3 Name of Act

Section 4 Relating to Political Subdivisions with Defined Benefit Plans External to TCRS

1. Definitions of certain terms
2. Requires development of a pension funding policy for fiscal years beginning after June 15, 2015
    a. Requires that the funding policy must include an actuarially determined contribution (ADC)
    b. Must establish a maximum amortization period for the unfunded accrued liabilities
    c. Provide for 100% funding of the ADC
    d. Funding policy must be submitted to comptroller of treasury within 30 days of adoption or amended
3. Requires that the actuarial methodology provide that projected revenues and current assets will finance the projected benefits calculated in accordance with Actuarial Standards of Practice by the Actuarial Standards Board

4. Certain minimum requirements for calculating the ADC

    a. Defines acceptable actuarial method, except that projected unit credit method is not permitted
    b. Actuarial value of assets limited to maximum 10 year smoothing with a 20% corridor
    c. Level dollar amortization must be used for unfunded liabilities by 2020
    d. Mortality assumption should consider the effects of expected improvement by 2024
    e. A closed maximum amortization period of 30 years
    f. Investment assumption cannot be in excess of 50 basis points greater than that used by TCRS
5. Define qualifications of an actuary that may be used by a political subdivision

    a. Shall be a member of the American Academy of Actuaries
    b. Independent, qualified
    c. Cannot be an employee of the political subdivision
    d. Cannot be a member of the pension plan
6. Requires payment of 100% or more of ADC

a. Provides maintenance effort plus a five year phase-in period for political subdivisions that are not paying 100% of ADC as of fiscal year 2015
b. Provides equal percentage incremental increases in payment of the ADC for five years until 100% is obtained;

7. For pension plans funded below 60%, the political subdivision may not enact benefit enhancements

8. For new hires, provides the authority to freeze, suspend or modify benefits, employee contributions, plan terms and design on a prospective basis for local governments electing to adopt provision.

   a. If adopted by local government, later of adoption by resolution of the chief governing body or the effective date of this act
   b. At all times, previously accrued benefits earned shall remain an enforceable right

9. Provides that commissioner of finance and administration, at the direction of the comptroller of the treasury, may withhold state shared taxes necessary to pay the ADC when a political subdivision fails to fund the required ADC. Funds withheld are paid to local government pension plan.

10. Authorizes a political subdivision to enter into an agreement with TCRS for management of plan assets

    a. Assets co-invested with TCRS assets
    b. Charged an asset management fee by TCRS. Fees must fully pay the state's cost
    c. Political subdivision maintains administration of the pension plan
    d. Evidence must be provided that plan assets are qualified assets
    e. TCRS not liable for benefits of the political subdivision

11. Authorizes a political subdivision to enter into an agreement with TCRS for both the administrative management of the pension plan and management of plan assets

    a. Local government determines plan design
    b. Assets co-invested with TCRS assets
    c. Charged an asset management fee by TCRS. Fees must fully pay the state's cost
    d. Charged an administrative fee by TCRS. Fees must fully pay the state's cost
    e. Evidence must be provided that plan assets are qualified assets
    f. TCRS not liable for benefits of the political subdivision

Section 4 Severability Clause

Section 5 Effective Date- Date of enactment

Attachment 1

Comparison of TCRS Administrative Cost to

Other Southeastern States

Attachment 1

Comparison of TCRS Administraive Cost to other Southeastern States

State	Plan Year	Net Assets Held in Trust for Pension Benefits (in billions)	Investment Expense (in millions)	Administrative Expense (in millions)	Active Members	Retired Members	Administrative Cost per Member	Investment Expense (basis points)
Florida	6/30/2012	119.98	376.72	16.62	623,011	333,364	17.38	31.4
Tennessee	6/30/2012	34.91	32.38	7.17	210,493	122,499	21.53	9.3
North Carolina	6/30/2012	82.70	360.30	20.56	485,681	240,001	28.33	43.6
Texas Combined	8/31/2012	134.32	211.42	51.96	1,174,286	428,641	32.42	15.7
Virginia	6/30/2012	52.09	300.22	26.33	341,826	162,751	52.18	57.6
Mississippi	6/30/2012	20.22	44.30	13.74	163,058	89,731	54.35	21.9
Alabama Combined	9/30/2012	28.14	7.52	22.18	205,650	120,622	67.98	2.7
South Carolina	6/30/2012	24.98	55.13	22.41	185,817	121,943	72.82	22.1
Arkansas Combined	6/30/2012	17.17	64.73	14.54	117,121	63,442	80.53	37.7
Georgia Combined	6/30/2012	67.15	24.93	36.73	252,334	112,429	100.70	3.7
Louisiana Combined	6/30/2013	23.71	92.55	31.82	136,865	110,379	128.70	39.0
Kentucky Combined	6/30/2012	25.56	62.49	35.55	121,701	84,782	172.17	24.4

Source- audited financial statements except Alabama where a management report was utilized

Attachment 2

Illustration of the costs of delaying employer pension contributions

Attachment 2

Cost of Delaying Employer Pension Contributions

Assumes a 7.5% Earnings Assumption

	Years of Deferral	Cost of Deferring $1 Million	Amount that must be Contributed by Deferring	Percentage Cost Increase
	1	75,000	1,075,000	7.5%
	2	155,625	1,155,625	15.6%
	3	242,297	1,242,297	24.2%
	4	335,469	1,335,469	33.5%
	5	435,629	1,435,629	43.6%
	6	543,302	1,543,302	54.3%
	7	659,049	1,659,049	65.9%
	8	783,478	1,783,478	78.3%
	9	917,239	1,917,239	91.7%
	10	1,061,032	2,061,032	106.1%
	11	1,215,609	2,215,609	121.6%
	12	1,381,780	2,381,780	138.2%
	13	1,560,413	2,560,413	156.0%
	14	1,752,444	2,752,444	175.2%
	15	1,958,877	2,958,877	195.9%

Attachment 3

Senate Bill 2079 – Senator Norris
House Bill 2037 – Representative McManus

SENATE BILL 2079

By Norris

AN ACT to amend Tennessee Code Annotated, Title 8, Chapter 37, Part 3 and Title 9, Chapter 3, relative to financial security for public defined benefit pension plans.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

SECTION 1. Tennessee Code Annotated, Title 8, Chapter 37, Part 3, is amended by adding a new, appropriately designated section as follows:

8-37-310.

(a) The state treasurer shall develop and recommend to the board of trustees a funding policy with respect to the obligations of the Tennessee consolidated retirement system. The board of trustees shall adopt a funding policy which complies with the provisions of this section. Such adopted funding policy shall be in effect until amended.

(b) For the purposes of this section, "Actuarially determined contribution (ADC), formerly known as the actuarially required contribution" means the actuarially determined annual required contribution that incorporates both the normal cost of benefits and the amortization of the pension plan's unfunded accrued liability.

(c) The funding policy established by the board of trustees shall include, but not be limited to the following:

(1) The ADC for the retirement system shall include the normal costs and the amortization of the unfunded accrued liability, to the extent that the retirement system has any unfunded accrued liability for a particular fiscal year;

(2) The maximum amortization period for which any unfunded accrued liabilities will be paid; and

(3) A statement that the retirement system's budget shall include funding of at least one hundred percent (100%) of the ADC.

(d) The actuarial methodology is expected to provide that projected revenues (employer contributions, employee contributions, and investment earnings), and current assets will finance all of the projected benefits (death, disability, and retirement) provided by the retirement system. In the event the retirement system has an unfunded accrued liability, then the level dollar amortization method shall be utilized for financing the unfunded accrued liability.

(e) The ADC calculated by the retirement system's actuary shall be calculated utilizing the following methodology, and in accordance with the Actuarial Standards of Practice established by the Actuarial Standards Board:

(1) Actuarial cost method allocating normal costs over a period beginning no earlier than the date of employment which should not exceed the last assumed retirement age. This method is designed to fully fund the long-term costs of promised benefits, consistent with the objective of keeping contributions relatively stable and equitably allocating the costs over the employees' period of active service. Entry age normal cost method shall be used to achieve this purpose;

(2) Actuarial value of assets calculated using a maximum ten (10) year asset smoothing period. Any smoothing period greater than five (5) years will have a maximum twenty percent (20%) market corridor. For the purposes of this subsection, the term "market corridor" means a range beyond which deviations are not smoothed;

(3) Level dollar amortization method of unfunded accrued liabilities;

(4) Mortality assumptions, which should consider the effect of expected mortality improvements, and shall be used no later than 2024;

(5) Investment earnings assumption based on the rate adopted by the board of trustees; and

(6) A closed amortization period not to exceed thirty (30) years for all unfunded accrued liabilities.

(f) In the event that an entity participating in the retirement system is funded below sixty percent (60%), such entity shall not establish benefit enhancements.

SECTION 2. Tennessee Code Annotated, Title 8, Chapter 37, Part 3, is amended by deleting sections 8-37-302, 8-37-303, 8-37-304, and 8-37-305 in their entirety.

SECTION 3. Tennessee Code Annotated, Title 9, Chapter 3, is amended by adding a new part thereto as follows:

9-3-501. This part shall be known and may be cited as "The Public Employee Defined Benefit Financial Security Act of 2014."

9-3-502. This act shall apply to political subdivisions that provide defined benefit plans not administered by the Tennessee consolidated retirement system.

9-3-503.

(a) As used in this part, unless the context otherwise requires:

(1) "Actuarially determined contribution (ADC), formerly known as the actuarially required contribution" means the actuarially determined annual required contribution that incorporates both the normal cost of benefits and the amortization of the pension plan's unfunded accrued liability.

(2) "Political subdivision" means any instrumentality of the state, or one (1) or more of its political subdivisions, but only if such instrumentality is a juristic entity which is legally separate and distinct from the state or subdivision and only if its employees are not by virtue of their relation of such juristic entity, employees of the state or subdivision.

(3) "Political subdivision employee" means any person in the employ of a political subdivision who participates in the political subdivision's pension plan.

(4) "Pension plan" means the defined benefit pension plan established and maintained by a political subdivision for its employees, excluding a political subdivision's participation in the Tennessee consolidated retirement system pursuant to title 8, chapters 34 through 37. The term "pension plan" shall include all pension plans that are open or closed to membership, and shall also include the plural, referring to any and all pension plans provided by a political subdivision.

(5) "Unfunded accrued liability" means the actuarially determined accrued liabilities of the pension plan that are greater than the actuarially determined value of the pension plan assets.

9-3-504.

(a) Notwithstanding any provision of law, rule, ordinance, resolution, charter, pension plan, agreement or pension plan contract to the contrary, the applicable provisions of this part shall apply to any political subdivision in the state that has established and maintains, directly or indirectly, a defined benefit pension plan for the benefits of its employees, irrespective of the manner in which the pension plan is administered.

(b) Each political subdivision shall develop a funding policy for financing the obligations under the pension plan. Such funding plan shall be legally adopted and approved through a resolution by the political subdivision's chief legislative body. The funding policy shall be in effect until amended. Each political subdivision shall develop a funding policy for fiscal years beginning after June 15, 2015. The funding policy and any amendment thereto shall be submitted to the comptroller of the treasury within thirty (30) days after adoption.

(c) The political subdivision's funding policy shall include, but not be limited to the following:

(1) The ADC for each pension plan shall include the normal costs and the amortization of the unfunded accrued liability, to the extent that any of the plans have any unfunded accrued liability for a particular fiscal year;

(2) The maximum amortization period for which any unfunded accrued liabilities will be paid; and

(3) A statement that the political subdivision's budget shall include funding of at least one hundred percent (100%) of the ADC, except as provided in §9-3-505(b).

(d) The actuarial methodology is expected to provide that projected revenues (employer contributions, employee contributions, and investment earnings), and current assets will finance all of the projected benefits (death, disability, and retirement) provided by the plan. In the event the pension plan has an unfunded accrued liability, then no later than the plan fiscal year commencing after June 15, 2020, the level dollar amortization method shall be utilized for financing the unfunded accrued liability.

(e) The ADC calculated by the political subdivision's actuary shall be calculated utilizing the following methodology, and in accordance with the Actuarial Standards of Practice established by the Actuarial Standards Board:

(1) Actuarial cost method allocating normal costs over a period beginning no earlier than the date of employment which should not exceed the last assumed retirement age. This method is designed to fully fund the long-term costs of promised benefits, consistent with the objective of keeping contributions

relatively stable and equitably allocating the costs over the employees' period of active service. Commencing with the plan fiscal year beginning after June 15, 2019, a generally accepted actuarial method that achieves the above objectives shall be used, except the projected unit credit method is not permitted;

(2) Actuarial value of assets calculated using a maximum ten (10) year asset smoothing period. Any smoothing period greater than five (5) years will have a maximum twenty percent (20%) market corridor. For the purposes of this subsection, the term "market corridor" means a range beyond which deviations are not smoothed;

(3) No later than the plan fiscal year beginning after June 15, 2020, the level dollar amortization method of unfunded accrued liabilities;

(4) Mortality assumptions, which should consider the effect of expected mortality improvements, and shall be used no later than the plan fiscal year beginning after June 15, 2024;

(5) Investment earnings assumption that shall not be greater than fifty (50) basis points above the rate adopted by the Tennessee consolidated retirement system; and

(6) A closed amortization period not to exceed thirty (30) years for all unfunded accrued liabilities.

(f) The ADC for the political subdivision's pension plan shall be determined by an independent, qualified actuary.

(g) The actuary used by the political subdivision shall be a member of the American Academy of Actuaries.

(h) The actuary used by a political subdivision for the calculation of the ADC for its pension plan shall not be an employee of that political subdivision, and shall not be otherwise eligible to participate in any of the political subdivision's pension plans.

9-3-505.

(a) A political subdivision shall annually pay a payment to the pension plan of no less than one hundred percent (100%) of the ADC; however, it may make a payment of more than one hundred percent (100%) of the ADC.

(b) A political subdivision that is not paying at least one hundred percent (100%) of the ADC to its pension plan for the fiscal year that includes June 30, 2015 shall maintain effort in the percentage of the ADC paid and, in addition thereto, in each subsequent year, pay the cumulative annual funding progress percentage to increase the funding percentage of the ADC to the pension plan until payment of one hundred percent (100%) of the ADC occurs within a maximum of five (5) consecutive years after June 30, 2015. The annual funding progress percentage is, as a minimum, the percentage determined by dividing by five (5) the difference between the percentage of the ADC paid in the plan fiscal year preceding July 1, 2015 subtracted from one hundred percent (100%). When payment of one hundred percent (100%) of the ADC occurs, the political subdivision shall continue to pay one hundred percent (100%) of the ADC annually. The ADC shall be recalculated each year and the percentage of funding shall be based on the most recent recalculation of the ADC.

9-3-506.

(a) The following provisions shall apply to all political subdivisions subject to this act:

(1) For political subdivision employees hired on or after the later of effective date of this act or the date that the following provision is authorized by

the political subdivision's chief legislative body by resolution, the political subdivision may freeze, suspend or modify benefits, employee contributions, plan terms and design on a prospective basis; and

(2) For any pension plan that is funded below sixty percent (60%), the political subdivision shall not establish benefit enhancements.

(b) For all political subdivision employees hired on or after the effective date of this act, the accrued benefits earned prior to any adjustment pursuant to subsection (a)(1) above shall remain an enforceable right and may not be reduced without the written consent of the employee.

9-3-507.

(a) In the event the political subdivision shall fail to fund the ADC according to the percentages established in § 9-3-505, the commissioner of finance and administration, at the direction of the comptroller of the treasury, is authorized to withhold such amount or part of such amount from any state-shared taxes that are otherwise apportioned to such political subdivision. The money withheld from state-shared taxes shall be paid to the political subdivision's pension plan.

(b) The deduction shall be made as a first charge against any moneys payable to such political subdivision regardless of the source of such payment and regardless of the purpose or contemplated use of such funds.

(c) Regardless of a political subdivision's funding level of its ADC, a political subdivision may, with the recommendation of the state treasurer and the approval of the board of trustees of the Tennessee consolidated retirement system:

(1) Continue the administration of its pension plan, but have the pension plan funds co-invested with the pension plan assets for the Tennessee consolidated retirement system, but established in a separate fund from the

Tennessee consolidated retirement system assets, and accounted for separately with accurate and detailed accounting records. The separate fund shall be operated in accordance with IRS Revenue Ruling 2011-1 or subsequent guidance regarding a group trust fund under Internal Revenue Code Section 401(a)(24). Before a political subdivision's pension plan assets are co-invested with Tennessee consolidated retirement system assets, the political subdivision shall provide the Department of Treasury with its plan document and a determination letter from the Internal Revenue Service that its plan assets are qualified assets or written advice from competent counsel of the Tennessee consolidated retirement system that the plan is a qualified plan. The political subdivision shall enter into an agreement with the retirement system for the co-investment of the political subdivision's pension plan assets, which shall include a charge assessed by the retirement system against the political subdivision for services related to the co-investment of assets; or

(2) Continue the pension plan, but have the plan administered by the Tennessee consolidated retirement system and have the assets co-invested with the Tennessee consolidated retirement system pension plan assets.

(A) The political subdivision shall enter into an agreement with the Tennessee consolidated retirement system to provide billing services, participant enrollment services, participant accounts, data processing, recordkeeping, investment and other related services that are necessary or appropriate to the administration of the political subdivision's pension plan. The agreement may provide that the services be provided directly by staff of the retirement system or through contracts with other providers.

(B) Any agreement entered into under this section shall require that the political subdivision remain the responsible administrator for the political subdivision's pension plan, and that neither the state of Tennessee nor the retirement system, or any of its officers, agents, employees, or boards shall act as a trustee or be considered the trustee for the political subdivision's pension plan.

(C) The chair of the retirement system shall assess a charge to the political subdivision for the administration of the political subdivision's pension plan and co-investment of its assets, in an amount to be determined by the chair, to meet the administrative expenses of the retirement system in providing the administration and co-investment services under this section. It is the legislative intent that the state shall realize no increased cost as a result of the administration of the political subdivision's pension plan and co-investment of its assets, and that all costs associated with the administration of the pension plan, including administrative and co-investment costs, shall be the responsibility of the respective political subdivision. In the event that the political subdivision refuses or otherwise fails to satisfy this liability, such amounts shall become a lien on the property of the political subdivision and may be withheld from state-shared taxes which are otherwise apportioned to the political subdivision.

(D) As a condition of providing the services described in this section for the administration of a political subdivision's pension plan, and at any time thereafter, the chair of the retirement system may require that the political subdivision provide proof that the political subdivision's pension plan is a qualified plan and otherwise complies with the applicable provisions of the Internal Revenue Code, as amended. The chair of the retirement system may require an opinion of counsel or other assurance satisfactory to the chair that the provision of the services described in this section does not cause the retirement system, the state, or any of their agencies or employees to violate any federal or state laws or regulations.

(E) Political subdivisions shall take all actions that the retirement system, in its discretion, deems necessary for compliance by the retirement system with all applicable federal and state laws or for qualification of the retirement system for any exemptions from regulation available under those laws, including, but not limited to, the federal Securities Act of 1933, as amended, and the Investment Company Act of 1940, as amended.

(F) The political subdivision's plan shall be administered separately from the Tennessee consolidated retirement system, and shall be administered according to the political subdivision's pension plan documents.

(G) The political subdivision's plan assets shall be established in a separate fund from the Tennessee consolidated retirement system assets, and accounted for separately with accurate and detailed accounting records. The separate fund shall be operated in accordance with IRS Revenue Ruling 2011-1 or subsequent guidance regarding a group trust fund under Internal Revenue Code Section 401(a)(24). Before a political subdivision's pension plan assets are co-invested with

Tennessee consolidated retirement system assets, the political subdivision shall provide the Department of Treasury with its plan document and a determination letter from the Internal Revenue Service that its plan assets are qualified assets.

(3) Notwithstanding any provision of the law to the contrary, through its administration of a political subdivision's pension plan, or the co-investment of the political subdivision's pension plan assets, as set forth in subdivisions (1) and (2) of this subsection, the Tennessee consolidated retirement system shall not be liable for the payment of any retirement allowances or other benefits on account for the political subdivision employees or their respective beneficiaries, for which reserves have not been previously created from funds contributed by the political subdivision or the political subdivision employees for such benefits.

SECTION 4. If any provision of this act or the application thereof to any person or circumstance is held invalid, such invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to that end the provisions of this act are declared to be severable.

SECTION 5. This act shall take effect immediately upon becoming a law, the public welfare requiring it.