TMRS
TEXAS MUNICIPAL RETIREMENT SYSTEM

September 7, 2007

Name
Title
City
Address
City, ST ZIP

Dear City Official:

This is the second in a series of important communications from TMRS to cities regarding potential changes in the Actuarial Cost Method and the Amortization Period used to determine the annual city contributions required to fund TMRS benefits.

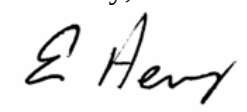
TMRS realizes that employers who have adopted annually repeating Updated Service Credit and Annuity Increases may see significant increases in their annual funding costs as a result of these potential changes. Further, the TMRS Board recognizes that employer budgets are already tight. Accordingly, we pledge to help employers accommodate these increased funding requirements. Specifically, we intend to allow employers to phase increased costs in over a period of years.

We are also evaluating whether a change in our investment policy would provide a greater level of investment income within acceptable levels of risk and liquidity. A higher level of investment income could benefit employers by partially offsetting potential future contribution requirements and could also help employees by preventing the possibility of considering reductions in future annuity calculations and further declines in future interest credits.

We will make our best effort to help employers through this challenging time while recognizing that our duty as fiduciaries is solely and exclusively to the members and beneficiaries of TMRS. In other words, while the Board is sensitive to the difficulties that rising pension contributions present to employers, the Board's fiduciary duty is to ensure that benefits promised to employees are adequately funded.

Above all, we want our member cities to understand that we are working to ensure the continuation of the sound funding status TMRS enjoys today.

Sincerely,



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Important Information for Cities

Estimated Effects of Actuarial Changes

On August 9, TMRS sent your city a letter showing historical cost information for your city's TMRS plan. Included in that letter was a discussion of two changes under consideration by the Board of Trustees:

- Change the Actuarial Cost Method from the Unit Credit Method to the Projected Unit Credit Method, to account for annually repeating Annuity Increases and Updated Service Credit. In addition to being a prudent actuarial practice, we believe the change is necessary to assure continued compliance with Generally Accepted Accounting Principles.
- Change the Amortization Period from a 25-year "Open" amortization schedule to a 25-year "Closed" schedule to expedite the pay-off of Unfunded Actuarial Accrued Liability (UAAL).

Please see that letter for a discussion of these two changes and related issues. If you need a copy of the information, a sample of the letter and the accompanying information can be found on the TMRS Website at http://www.tmrs.com/bulletins/sample_packet.pdf.

In October, TMRS will provide each city with a letter showing the effect of those two changes on the city's individual plan – also taking into account the results of the actuarial experience study currently in progress.

At the TMRS Board of Trustees joint meeting with its Advisory Committee, the TMRS actuary presented a series of charts showing the estimated effects of the changes in Actuarial Cost Method and Amortization Period on a selection of sample cities. This letter contains a discussion of one sample city to show the estimated effects of the changes and to draw your attention to the difference in actuarial costs for a city that has adopted automatic annual Annuity Increases (AI) and Updated Service Credit (USC).

A few important points to remember:

- No matter what cost method or amortization period is used, the total cost of benefits remains the same. What changes is the schedule under which those benefits are being funded.
- Every city will be affected differently, due to the city's actuarial history, workforce composition, and current liability.
- If the Board chooses to adopt these policy changes, they will be implemented gradually over a period of years, allowing employers' budgets to absorb any increased costs in a gradual, predictable fashion.
- The current TMRS Actuarial Cost Method does not recognize any future costs or liabilities associated with annually repeating USC and Annuity Increases.
- With 15 years of experience, TMRS believes that these annually repeating benefits constitute a "committed benefit" under Governmental Accounting Standards Board (GASB) rules. Thus, all future costs and liabilities associated with automatic AI and USC need to be included in the total liabilities examined in each year's actuarial valuation.
- As a fiduciary, the TMRS Board's duty is to assure that the benefits that employers have promised to employees are soundly funded. Unit Credit does not pre-fund annually repeating AI and USC, but Projected Unit Credit will.
- The figures in the following charts represent actuarial projections. In actual practice, over time, the lines representing contribution rates, UAAL, and Funding Ratios will vary slightly from year-to-year due to favorable and unfavorable actuarial experience.

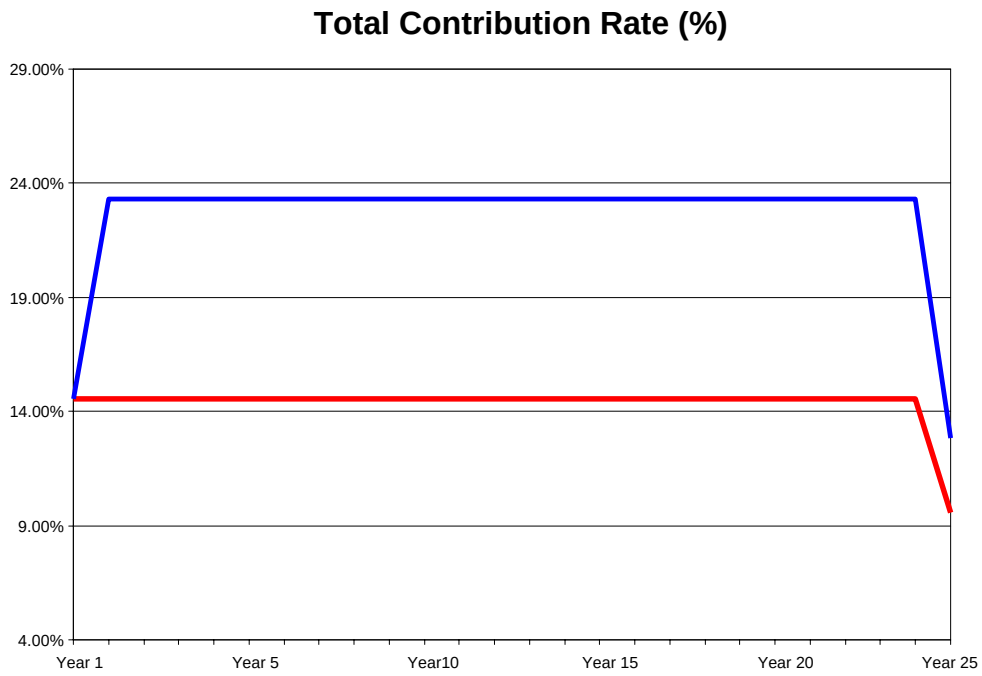
EFFECTS ON A SAMPLE CITY

This city offers "full" benefits: an employee deposit rate of 7%; 2 to 1 city match; 5-year vesting; 20-years-at-any-age retirement; annually repeating 100% USC and 70% CPI Annuity Increase.

For valuation purposes, this city has a 5% payroll growth assumption. In 2007, this city has a Funded Ratio of approximately 82% and a Contribution Rate just above 14.5%.

In each of the following charts, the **Blue Line** represents the city's current plan under the new Projected Unit Credit Actuarial Cost Method, with a 25-year Closed Amortization Period.

The **Red Line** also represents the city's current plan, but without **any** USC or Annuity Increases during the 25-year period. **IMPORTANT NOTE: The liability associated with these increases is the same whether they are granted on an annually repeating or an ad hoc basis every year.**



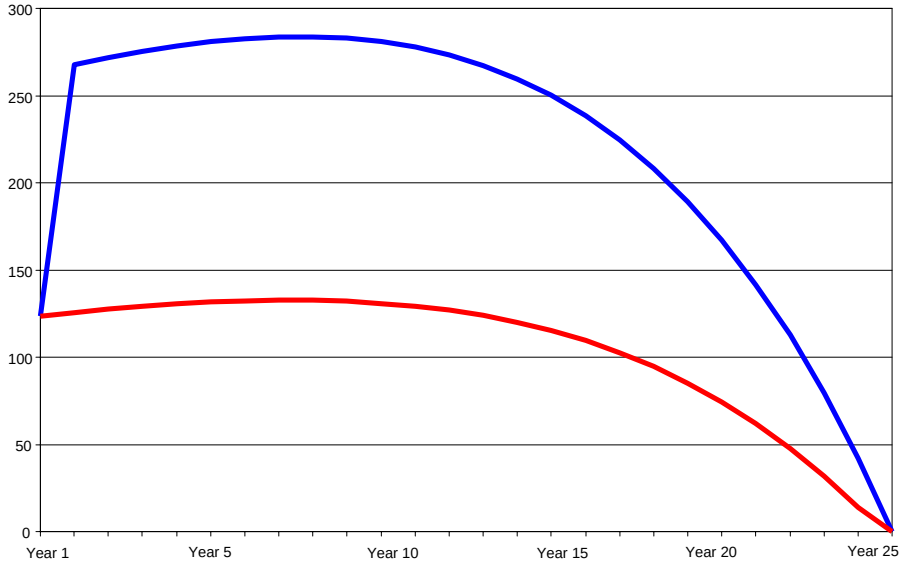
The above graph shows that, in the first year under a sound funding methodology (i.e. Projected Unit Credit), the Total Contribution Rate rises sharply and continues at that level over the 25-year Closed Amortization Period (**Blue Line**). At the end of the 25-year period, the plan's Unfunded Actuarial Accrued Liability (UAAL) will be amortized, and the contribution rate will fall to the plan's Normal Cost. The liability for annually repeating benefit increases has been advance-funded.

Remember, the **Red Line** shows the contribution rate **without any USC or Annuity Increases, either annually repeating or ad hoc.** Without benefit increases, the current contribution rate stays level for 25 years and then will fall to the plan's Normal Cost. Note that the Normal Cost is lower for a plan without annually repeating benefit increases.

Essentially, this chart portrays the difference between two sound alternatives, one in which automatic annual AI and USC are in effect and funded in a sound fashion and one in which no future AI or USC are granted. Those cities that choose to pursue ad hoc AI or USC in future years

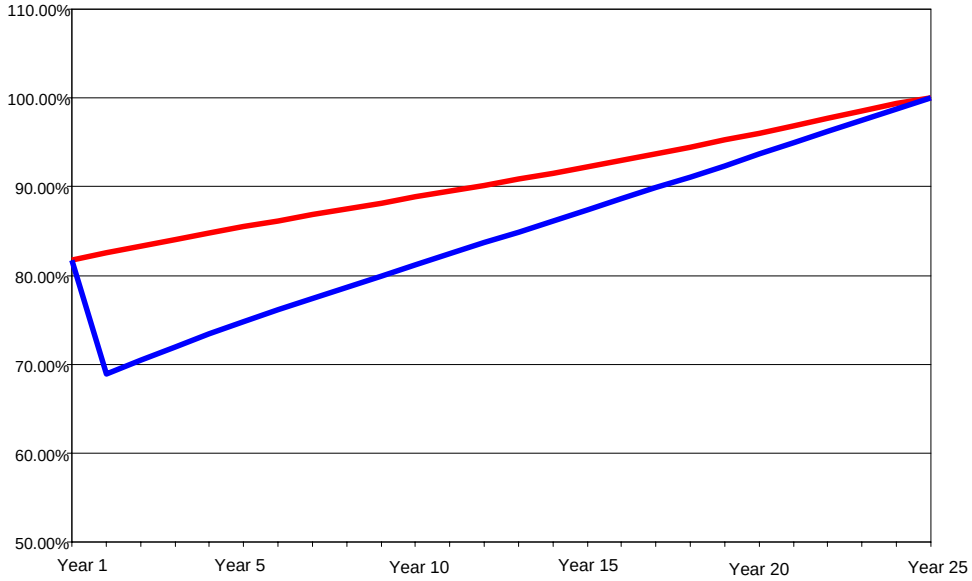
as their budgets allow will see that the additional costs of such benefit enhancements will increase employer contribution rates and unfunded actuarial liabilities, while eroding their funding ratios.

Unfunded Actuarial Accrued Liability (UAAL) ($millions)



As the UAAL chart above shows, under a 25-year Closed Amortization Period, with or without benefit increases, the UAAL is fully amortized at the end of the period. The difference is that the liability associated with future benefit increases raises the UAAL to a significantly higher level, requiring a high contribution rate to amortize the liabilities.

Funded Ratio (%)



The **Blue Line** on the final chart shows the plan's funding progress over the 25-year period under the new Actuarial Cost Method and Amortization Period. In the first year, with full recognition of the liability associated with annually repeating benefits, the UAAL rises (as shown in Chart 2) and the

Funded Ratio declines (Chart 3). Under the 25-year Closed Amortization Period, however, the Funded Ratio improves steadily. The **Red Line** shows similar progress but assumes no liability is added in the future associated with any AI or USC.

SUMMARY

Continuing to grant USC and AI creates large actuarial liabilities that are not pre-funded under the current actuarial methodology. Over time, unless the actuarial methodology is changed, these committed benefits will cause contribution rates and UAAL to rise and Funded Ratios to decline. A change to the Projected Unit Credit Actuarial Cost Method will pre-fund these benefits in accordance with GASB standards and, in time, result in stable contribution rates.

These graphs should give you some idea of the potential effect of the recommended actuarial changes, show you the true cost of annually repeating AI and USC, and should help illustrate some of the concerns about increasing liabilities resulting from annually repeating benefits.

The recommendations that the TMRS Board is considering will pre-fund benefits that are currently being funded one year at a time. The pre-funding will result in positive funding progress each year. After 25 years, when the UAAL reaches zero, the cost of annually repeating benefits becomes part of the plan's ongoing Normal Cost.

TMRS is continuing to explore ideas with regard to its actuarial methods and amortization periods and is committed to working with cities to maintain the soundness of each TMRS plan while providing reasonable benefits to employees.

We will continue to keep you informed as new developments occur.