Texas Municipal Retirement System
GASB Update

September 19, 2014

Joseph Newton, Leslee Hardy
and Rhonda Covarrubias

GRS Gabriel Roeder Smith & Company
Consultants & Actuaries
www.gabrielroeder.com

Today’s Agenda

- GASB Recap
- “New” Pension Expense
- Smoothed versus Market Assets
- Discount Rate
- Funding Policy
- “Substantively” Automatic Benefits
- Implementation Status Update

Timing

- GASB No. 67 Plan Reporting
  - Effective for fiscal years beginning after June 15, 2013
  - For TMRS, December 31, 2014 financial statements
- GASB No. 68 Employer Reporting
  - Effective for fiscal years beginning after June 15, 2014
  - For TMRS member cities: fiscal years ending in June 30, 2015 through May 31, 2016 financial statements
    - Includes TMRS as an employer
    - Local employers could vary depending upon their fiscal year end

What has GASB done?

- The Statements change current pension accounting and financial reporting standards for state and local governments
  - Disconnect pension accounting from pension funding
  - Total Pension Liability (TPL) code for Actuarial Accrued Liability
  - Require employers to recognize the Net Pension Liability (NPL) on their balance sheets (where NPL is code for the Unfunded Accrued Liability based on Market Value of Assets)
  - Require employers to recognize a new measure of the Pension Expense (PE) on their income statements, which would be different from their actuarially determined contributions (ARC)
  - Replace most of the current note disclosures and required supplementary information with information based on the new measures

Big Picture

- There could be a liability on the employers' books that is larger than ever seen before
  - It also could be an asset!
  - It will impact all retirement systems and all TMRS cities
  - This will be a "bumpy" liability; changing each year with a new blended discount rate and change in market value of assets, if applicable
- There could be an expense on the employers' books that is a larger expense than ever seen before
  - There could be income!
  - The shorter amortization period will accelerate recognition of pension cost
- The changes only impact the accounting rules, but …..

The Before and After

	GASB 25/27	GASB 67/68
Liability	Up to six allowable actuarial cost methods, plus variants of each	Only Individual Entry Age allowed
Asset	Various asset smoothing methods allowed	Fair market value
Expense	Various amortization periods and methods allowed	Rigid rules for Pension Expense components
LTeROR (Discount Rate)	Flexible on plan's return assumption	Still flexible on plan's return assumption to the extent assets are available to cover liabilities

LTeROR – Long Term Return Assumption, also the discount rate

The "New" Pension Expense

- Pension Expense:
  - Under Statement 27, pension expense represented the annual required contribution (ARC) needed to pay future benefits
  - Under Statement 68, pension expense largely represents the change in the Net Pension Liability from the prior year, with provisions for deferring certain items

The "New" Pension Expense

- Items <u>immediately recognized</u> in pension expense include:
  - Service cost (additive)
  - Interest on TPL (additive)
  - Projected investment earnings (subtractive)
  - Actual member contributions (subtractive)
  - Administrative costs (additive)
  - Changes in TPL due to changes in benefits

The "New" Pension Expense

- Certain other changes are treated as "deferred outflows of resources" and "deferred inflows of resources"
  - Changes in the plan's fiduciary net position due to differences between projected investment earnings and actual investment earnings
    - Recognized over a closed 5-year period
  - Changes in total pension liability due to (1) changes in assumptions or (2) differences between assumed and actual actuarial experience
    - Recognized over a closed period reflecting average remaining service life of all members (active, inactive, and retirees)

Expense Examples

	GASB 67/68	GASB 25/27
Expense		
1. Service Cost	$ 5,511,524	$ 5,511,524
2. Interest on the Total Pension Liability	22,610,893	-
3. Current-Period Benefit Changes	0	0
4. Employee Contributions	(3,305,372)	(3,305,372)
5. Projected Earnings on Plan Investments	(21,349,330)	-
6. Pension Plan Administrative Expense	194,014	0
7. Other Changes in Plan Fiduciary Net Position	0	0
8. Recognition of Outflow (Inflow) of Resources due to Liabilities	(45,207)	-
9. Recognition of Outflow (Inflow) of Resources due to Assets	0	-
Amortization of UAAL (20 Year)		2,082,809
10. Total Pension Expense	**$ 3,616,522**	**$ 4,288,961**

	GASB 67/68	GASB 25/27
Net Pension Liability		
Total Pension Liability	$ 341,764,756	
Plan Fiduciary Net Position	323,356,369	
Net Pension Liability	$ 18,408,387	
Plan Fiduciary Net Position as a Percentage of Total Pension Liability	94.61%	
Actuarial Accrued Liability		$ 341,764,756
Smoothed Value of Assets		313,036,550
UAAL		$ 28,728,206
Funded Ratio		91.59%

Difference in Asset Values

- Currently, the market assets are higher than the smoothed assets
- In that situation, the accounting "NPL" will be smaller than the funding "UAAL"
- Thus, currently, the accounting NPL next year is expected to be smaller than the funding UAAL
- However, that is not going to be consistently true. There will be times that the opposite is true. Also, the accounting NPL will be substantially (literally 10x) more volatile than the funding UAAL

Sensitivity to Market Returns

Investment Earnings for Year	17%	7%	-3%
Expense			
1. Service Cost	$ 5,511,524	$ 5,511,524	$ 5,511,524
2. Interest on the Total Pension Liability	22,610,893	22,610,893	22,610,893
3. Current-Period Benefit Changes	0	0	0
4. Employee Contributions	(3,305,372)	(3,305,372)	(3,305,372)
5. Projected Earnings on Plan Investments	(21,349,330)	(21,349,330)	(21,349,330)
6. Pension Plan Administrative Expense	194,014	194,014	194,014
7. Other Changes in Plan Fiduciary Net Position	0	0	0
8. Recognition of Outflow (Inflow) of Resources due to Liabilities	(45,207)	(45,207)	(45,207)
9. Recognition of Outflow (Inflow) of Resources due to Assets	(6,099,808)	0	6,099,809
10. Total Pension Expense	**$ (2,483,286)**	**$ 3,616,522**	**$ 9,716,331**
Net Pension Liability			
Total Pension Liability	$ 341,764,756	$ 341,764,756	$ 341,764,756
Plan Fiduciary Net Position	353,855,411	323,356,369	292,857,326
Net Pension Liability	$ (12,090,655)	$ 18,408,387	$ 48,907,430
Plan Fiduciary Net Position as a Percentage of Total Pension Liability	103.54%	94.61%	85.69%
AVA	316,086,455	313,036,550	309,986,646
UAAL	$ 25,678,301	$ 28,728,206	$ 31,778,110
Funded Ratio	92.49%	91.59%	90.70%

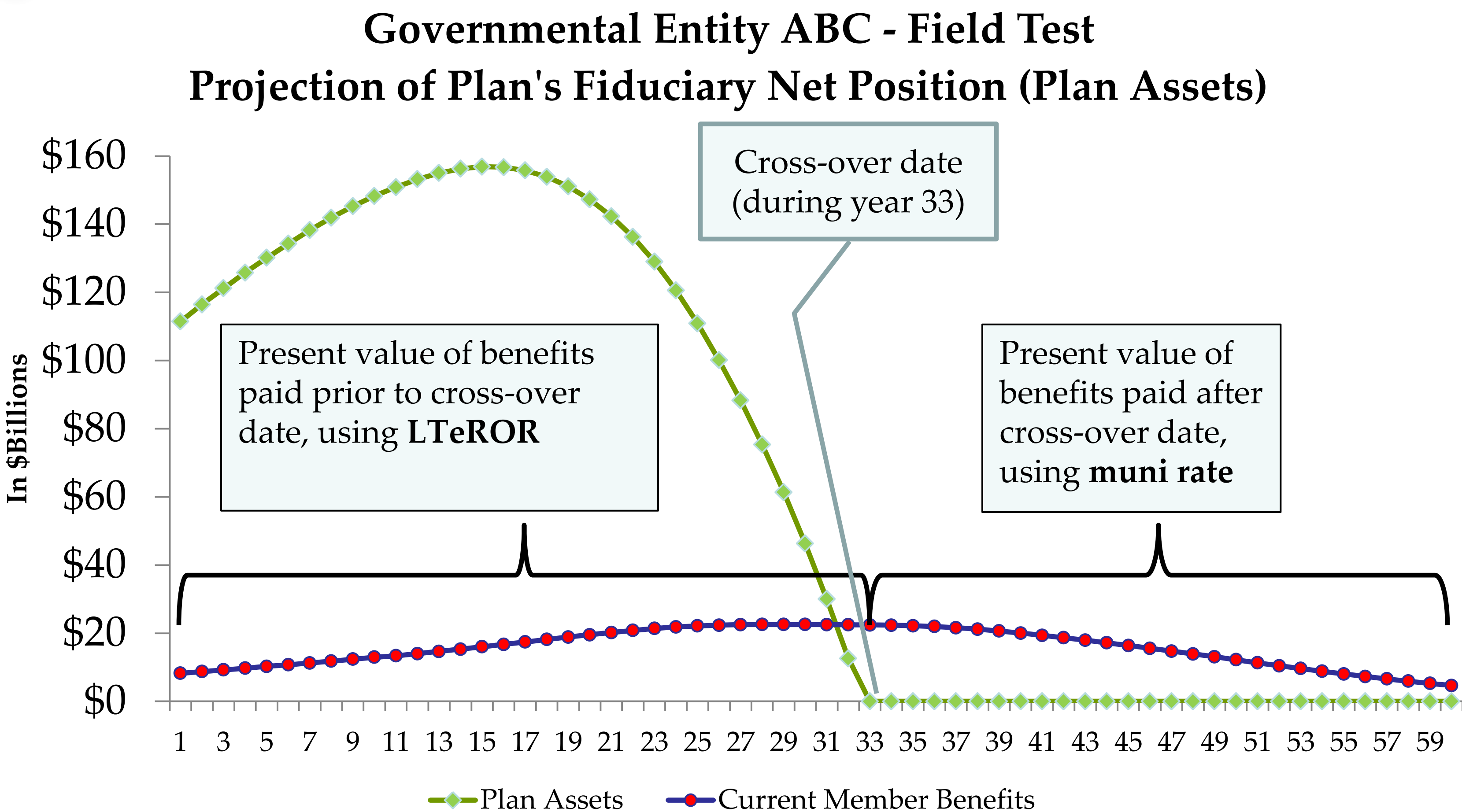
Determining the Discount Rate

- Discount rate used in determining the Total Pension Liability (TPL) is a blend of two rates:
  - Long-term expected rate of return on plan investments
    - This rate is generally consistent with the funding valuation
    - 7.00% for TMRS
  - Yield or index rate for a 20-year, tax-exempt general obligation municipal bond
    - Will vary
    - ~4.0%
- Weight given to the long-term rate is based on a closed group projection

Determining the Discount Rate

- The premise…
  - The pension plan is primarily responsible for paying pension benefits to the extent the plan has sufficient assets
    - Assets invested with long-term investment horizon
  - The employer is primarily responsible for paying benefits to the extent the plan does not have sufficient assets
    - From the general fund or bond revenues

Illustration



Using a 4% muni rate – The blended discount rate in this example would be approximately 6.00%

We expect all TMRS administered plans to pass this test and be able to use 7.00%. However, as always with 850 cities, anomalies may exist

Funding Policy

- The "Funding Policy" of a Pension Plan is a systematic set of procedures used to determine the contributions which will be made in a specific year and series of years
- It is much broader in scope than most people think
- It must address how the contributions will be made for ongoing benefits as well as how to finance gains or losses as experience occurs

Elements of a Funding Policy

- Actuarial Cost Method
- Asset Smoothing Method
- Amortization Methods
  - Level dollar vs Level Percentage of Payroll/Budget
  - For initial liabilities
  - For changes in assumptions
  - For changes in benefit provisions
  - For gains and losses (deviations from expectation) that naturally occur
- Actuarial Assumptions

Current TMRS Funding Policy

- TMRS does have a current policy
  - Mostly defined in statute
  - Some defined further by Board rules or resolution
- Employers must contribute the normal cost plus a closed amortization of any UAAL that exists
- Ad hoc benefit enhancements are amortized over a shorter period and on a level dollar schedule
- Small plans have accelerated schedules
- Closed plans are amortized over shorter period and on level dollar schedule
- For the new GASB disclosures, these policies will need to be written in a summarized, concise format and adopted by the Board

Funding Policy Impact on Discount Rate Determination

- The Discount Rate test is actually a Funding Policy test
  - The Funding Policy applied in the projection will dictate whether the System passes or fails
    - Current funded status is not very relevant
    - Current poorly funded systems with strong prospective funding policies will pass
    - Current well funded systems with weak prospective funding policies will fail
- Since TMRS is both well funded and has a strong funding policy, the system will pass
- Only scenario where a TMRS city *might* fail under current funding policy
  - A City granting annual ad hoc COLAs
  - And is currently relatively poorly funded

Funding Policy – Idea for Future Consideration

- The Discount Rate test is actually looking to see if the liability for the current population is going to be fully financed over their expected lifetime, or is it going to be pushed to a future generation
- No current TMRS cities are expected to fail, but, there is one change that could be considered to the current ad hoc funding policy that would eliminate the chance entirely:
  - Set the amortization period for ad hoc COLAs to be the lesser of
    - The current 15 year policy or
    - The average remaining life expectancy of the retirees receiving the ad hoc COLA
- Waco is currently the lowest at 18 years (of the cities who are granting ad hoc COLAs)
- This change would likely never actually impact a City's contribution, but in the projection test, it would guarantee that any liability for the current population is completely financed over their expected lifetime
- This is not a current recommendation, but may be considered at a future point in time

"Substantively" Automatic Benefits

- From GASB 67/68 for determining plan liabilities :
  - "Projections also are required to include the effects of ad hoc postemployment benefit changes (including ad hoc COLAs), if they are considered to be substantively automatic."
- Thus, even Cities that are not providing repeating benefits may have to include an assumption of future ad hoc COLAs if it is determined their benefit is "substantively automatic"
- However, GASB 67/68 do not provide a definition of "substantively automatic"

"Substantively" Automatic Benefits

- **Definition of Automatic cost-of-living adjustments (automatic COLAs)**
  - Cost-of-living adjustments that occur without a requirement for a decision to grant by a responsible authority, including those for which the amounts are determined by reference to a specified experience factor (such as the earnings experience of the pension plan) or to another variable (such as an increase in the consumer price index).
- From footnote in GASB 67/68:
  - Considerations that might be relevant to determining whether such changes are substantively automatic include the historical pattern of granting the changes, the consistency in the amounts of the changes or in the amounts of the changes relative to a defined cost-of-living or inflation index, and whether there is evidence to conclude that changes might not continue to be granted in the future despite what might otherwise be a pattern that would indicate such changes are substantively automatic.
- From GASB 68 Implementation Guide:
  - 55. *Q*—A defined benefit pension plan's enabling statute provides that the board of trustees can annually authorize a COLA not to exceed a specified percentage increase or the change in the consumer price index, whichever is lower. The maximum allowable COLA has always been authorized. Should the effects of this COLA provision be included in the projection of future benefit payments?
  - *A*—This COLA is not automatic because approval of the board of trustees is required to authorize the benefit increase. Therefore, the effects of the COLA provision should be included in the projection of future benefit payments only if the provision is evaluated to be *substantively automatic.*

“Substantively” Automatic Benefits

- Applicable definitions of substantively (from Google):
  - Having the nature or function of
  - Having a real existence

- From GASB 43/45:
  - The projection of benefits should include all benefits covered by the current substantive plan (the plan as understood by the employer and plan members)

"Substantively" Automatic Benefits TMRS Specific

- The catch-up feature of the TMRS COLA produces a similar liability whether a City provides an ad hoc every year, every other year, or even every third year
- Thus, the COLA needs to be grouped into two categories: (1) granting them or (2) not
- Also, the USC is also a benefit provision that will need to be treated similarly

Proposed Default Position for "Substantively" Automatic Benefits

- The following is our proposed default criteria for determining whether a USC/COLA is substantively automatic:
  - 1. Repeating provisions will be treated as substantively automatic (same as current funding valuation)
  - 2. For Cities who grant ad hoc benefits, the benefits will be defined as substantively automatic if:
    - They have been granted 1 of the last 2 years; AND
    - They have been granted 2 of the last 5 years
    - This default criteria will be applied with the first ad hoc adoption on or after January 1, 2015 – Fresh Start
      - If a City does not grant a January 1, 2015 COLA, we will not apply the criteria
      - However, if a City does grant a January 1, 2015 COLA or, the first time a City does grant one after January 1, 2015, we will apply the criteria that year, and annually thereafter

Example City – Underfunded with Annual Ad hoc COLAs & USCs

(2:1 match, no repeating COLAs)

	Funding Results with Ad hoc 100% USC & 70% COLA Adoption (no repeating)	Accounting Results with Repeating 100% USC & 70% COLA Assumption
Actuarial Accrued Liability / Total Pension Liability	$386,798	$480,753
Actuarial Value of Assets / Net Position	343,956	374,912
Unfunded Actuarial Accrued Liability / Net Pension Liability	$42,842	$105,841
Funded Ratio / Plan Fiduciary Net Position as a Percentage of Total Pension Liability	88.9%	78.0%

$ amounts shown above are in thousands

Implementation Status Update

- Per AICPA SLGEP whitepaper for agent multiple-employer plans, best practice solution for TPL, PE and Deferred I/O's
  - 1. Plan engages its auditor to issue a service organization controls (SOC 1) Type 2 report on controls over census data maintained by the plan and fiduciary net asset additions & deductions

    and
  - 2. Plan actuary issues a separate actuarial valuation report specific to each employer, which includes an actuarial certification letter addressed to employer management

SOC-1 Type 2 Audit

This audit must cover the valuation period (Jan 1 – Dec 31, 2014) plus the interest allocation period (to March 31, 2015)

- 1. This first SOC audit will be for a 15-month period, with report issued in May, 2015.

KPMG completed Phase 1 testing in May-June

- Phase 2 scheduled for Nov-Dec 2014
- Phase 3 scheduled for March-April 2015

SOC-1 Type 2 Audit – (continued)

First draft of written processes/controls narrative (contained in report) has been completed and forwarded to KPMG.

- expect several back-and-forth reviews/edits

Current plan = provide SOC audit report to cities via City Portal

SOC-1 Type 2 Audit – (continued)

TMRS reminding cities about <u>user-entity controls</u> (initially provided in March, 2015 potential audit implications letter provided to all cities)

- Email reminder sent to first-quarter cities (approx. 50)
  - Cities with fiscal year beginning July, Aug., & Sept.
- Preparing for next email reminder to second-quarter cities (majority of TMRS cities - approx. 720)
  - Cities with fiscal year beginning Oct., Nov., & Dec.

Employer (City) GASB Reporting Package

- GRS has provided first draft of "Employer GASB reporting package"
  - being reviewed by Covarrubias and Bob Scott (Carrollton) for city-perspective

- Reporting package includes:
  - Certification letter addressed to city
  - Calculation of the discount rate
  - Calculation of pension expense and deferred I/O's
  - Numerous disclosure items

Current plan = distribute pdf (by city) on TMRS website (similar to funding valuation) – June 2015

QUESTIONS ??

Disclaimers

- Circular 230 Notice: Pursuant to regulations issued by the IRS, to the extent this presentation concerns tax matters, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) marketing or recommending to another party any tax-related matter addressed within. Each taxpayer should seek advice based on the individual's circumstances from an independent tax advisor.

- This presentation shall not be construed to provide tax advice, legal advice or investment advice.

- Readers are cautioned to examine original source materials and to consult with subject matter experts before making decisions related to the subject matter of this presentation.

- This presentation does not necessarily express the views of the sponsoring organization, or of Gabriel, Roeder, Smith & Company, and may not even express the views of the speakers.