

Important Consideration Regarding Financing Retirement Obligations Tennessee Consolidated Retirement System (TCRS)

General Information

Since 1972, the Tennessee General Assembly, Governor and all local governments that participate have funded 100% of the employer contribution rate (Actuarial Determined Contribution rate) in accordance with State law. Because of this commitment, TCRS is one of the strongest funded plans in the nation and pension plans for most employers participating in TCRS are well funded.

However, that does not mean that there will not be challenges prospectively regarding the financing of retirement benefits. Two specific items of concern are investment challenges and continued improvement in mortality. In addition, there are unique challenges for smaller employers. Accordingly, there is a potential for upward pressure on employer contribution rates in the future. Your governmental entity needs to prepare for such possibility. Further, the Actuarial Experience Study, conducted by TCRS every 4 years, reflected that a reduction in the investment earnings assumption was needed. Therefore, in 2017 the TCRS Board of Trustees took action to lower the investment earnings assumption from 7.5% to 7.25%. What seems like a small reduction will impact employer contribution rates.

Specific funded status information for each participating employer will be provided in May of this year. The financial information will be pursuant to GASB 68 and will be in the same format as last year. However, that information only provides the funded status at a point in time and does not give an indication of future challenges relative to employer payments toward pension cost. This document is intended to address factors that may potentially increase employer contribution rates.

Potential Impact of the Financial Marketplace

Investing retirement plan assets greatly impacts the funded status of a plan and the employer contribution rates. Historically, investment earnings represent more than 60% of the revenue to finance retirement benefits. In determining employer contribution rates, the actuarial calculations assume a long-term annualized rate of return of 7.25% as adopted by the TCRS Board of Trustees on September 29, 2017. As can be the case with any long-term expected return, there can be periods that do not meet the 7.25% expectation. The current market volatility makes the 7.25% assumption more difficult to attain in the near term. The investment return for fiscal year ending June 30, 2017 was 11.4%. You should know that even with no other factors that this memo addresses, the investment returns alone can put upward pressure on employer contribution rates.

Potential Impact due to Improving Mortality

As people continue the pattern of living longer due to improving medical treatments and more knowledge about how to live healthier, the result is that retirement benefits are paid longer. Paying retirement benefits for a longer period of time than assumed increases the employer contribution rate.

The TCRS actuarial calculations use mortality assumptions that equates to the current pattern of mortality plus some, but not all, of the expected improvement. As a result of the June 30, 2016 experience study, TCRS projected mortality 6 years beyond the actuarial valuation date.

Potential Impact of Smoothing Methodology

TCRS utilizes a 10-year smoothing methodology for investment returns to control employer rate volatility. Essentially, a portion of the investment gains or losses are recognized each year. The delay in the recognition of losses causes the actuarial value of assets to be larger than the market value of assets. Conversely, the delayed recognition of gains will cause the actuarial value of assets to be lower than the market value of assets. As a reminder, the market value of assets is used in financial statements and for GASB reporting purposes.

Other Actuarial Assumptions

While investment earnings and mortality can impact employer contribution rates to a great degree, other actuarial assumptions impact rates. Employer turnover, salary, early/late retirement and cost of living adjustments are all assumptions that can have positive and/or negative impacts to employer contribution rates.

Impact for Employers with few Employees

There can be greater volatility in the employer contribution rate for employers with few employees. Employers with less than 100 employees can expect to realize volatility in the employer contribution rate each actuarial valuation.

Unfunded Liability

Unfunded liability is part of an employer's contribution rate. The faster the unfunded liability is paid off, the less impact on future rates. Furthermore, GASB 68 requires the pension liability to be reflected on the employer's financial statements. Additional contributions above the actuarially determined contribution (ADC) may lower this value.

Consider paying more than the Minimum Employer Contribution Rate

Understanding that even small percentage changes to governing body budgets can cause great impact to a community's fiscal priorities, TCRS aims to educate entities of the potential for volatility. TCRS strongly encourages a proactive approach to funding pension obligations. As you review your employer contribution rates for your legacy plan for this year, we strongly encourage you to adopt an employer rate that is higher than the minimum amount. This option is not applicable for the hybrid plans with cost controls. Options to consider include:

- If your new employer rate is lower, consider staying at the same level you are at now
- If your employer rate is less than 2%, consider paying at least 2% or more

- If you have a relatively low employer rate, consider paying more than the minimum required rate
- If your rate is increasing, consider future budget years and weigh your options for paying more now

By paying more into TCRS, you help mitigate the potential upward pressure of increasing employer contributions in future years. Moreover, you reduce any net pension liability that will be reflected as debt in your financial statements.

TCRS wants to help you understand the rate that is best for you and your budget being mindful that the upward pressure on rates for the next annual valuation period is very strong. Any additional contributions that can be made will help offset increases in future years.

Again, TCRS is one of the best funded plans in the nation because of its prudent financial management and the prudent financial management of all of our members. We welcome the opportunity to work with you to continue to provide retirement for Tennesseans.

What other options are available?

We encourage you to actively discuss with us all aspects of your retirement program. There are alternative plan provisions that would assist with future retirement cost and the long term impact could be significant.

Please reach out to the following employees for assistance if you want to discuss your employer contribution rate and other options.

Tennessee Treasury Outreach Team

Drew Freeman, Director
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