

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 in TCRS have funded 100 percent 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; however, that does not mean that there will not be future challenges regarding the financing of retirement benefits.

Two specific areas impacting defined benefit plans are investment market volatility and continued improvement in mortality. As a result of the most recent experience study conducted on June 30, 2016, the TCRS Board of Trustees took prudent action in 2017 to lower the long-term investment earnings assumption from 7.5 percent to 7.25 percent and to incrementally recognize improvements in mortality. While these changes may seem minor, they will impact employer contribution rates. Furthermore, there is no way to fully insulate the plan from the unpredictability of the investment market.

Pursuant to GASB 68, specific funded status information for each participating employer will be provided later this year. This financial statement information can be helpful in evaluating the current health of your plan; however, it is important to note that the funded status is captured at a point in time and does account for future challenges. This document is intended to address those factors and their impact on 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 percent of the funding necessary for financing retirement benefits. In determining employer contribution rates, the actuarial calculations assume a long-term annualized rate of return of 7.25 percent, 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 percent expectation. The current market volatility makes the assumption more difficult to attain in the near term. The investment return for the fiscal year ending June 30, 2018 was 8.19 percent; however, the return for the current fiscal year is tracking well below the 7.25 percent assumption. Ignoring all other factors addressed within this document, investment returns below the long-term expected return 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 increased knowledge about how to live healthier, retirement benefits are being paid longer. Paying retirement benefits for a longer period of time than assumed increases the employer contribution rate.

As a result of the June 30, 2016 experience study, under the legacy plan, TCRS projected mortality 6 years beyond the actuarial valuation date. Through this action, TCRS has assumed some expected

improvements in mortality; however, the expected improvements are not forecasted to be fully phased in until the next experience study in 2024.

Expected improvements in mortality have been fully recognized under the TCRS component of the hybrid plan.

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 delayed recognition of losses causes the actuarial value of assets to be larger than the market value of assets. Conversely, the delayed recognition of gains causes 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 also play a role. 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

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

Contribution Rate Considerations for Legacy Plan Participants

Understanding that even small percentage changes to an entity's budgets can shift 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 consider adopting an employer rate above the minimum amount. Options to consider include:

- If your new employer rate will be lower, consider staying at the same level you are at now
- If your employer rate will be 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.

Should you need further assistance in evaluating your employer contribution rate or wish to discuss alternative plan provisions, please reach out to your regional Outreach Representative.

Treasury Outreach

Drew Freeman, Director

Cell: (615) 806-4467

Drew.Freeman@tn.gov

East TN Representative: Justin Ball

Cell: (423) 356-1518

Justin.Ball@tn.gov

Middle TN Representative: James Armistead

Cell: (615) 289-4447

James.Armistead@tn.gov

West TN Representative: Tim Joyce

Cell: (901) 233-4517

Tim.Joyce@tn.gov