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The Teachers' Retirement Fund's
Pension Stabilization Fund
A Trust Fund Insuring Indiana's Commitments

Mark D. Brown
Research Director

March 2005
Report 23

**THE TEACHERS' RETIREMENT FUND'S
PENSION STABILIZATION FUND
A TRUST FUND INSURING INDIANA'S COMMITMENTS**

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THE TEACHERS' RETIREMENT FUND'S PENSION STABILIZATION FUND A TRUST FUND INSURING INDIANA'S COMMITMENTS

EXECUTIVE SUMMARY

This Indiana Fiscal Policy Institute Report reviews the current condition of the Teachers' Retirement Fund (TRF) and the Pension Stabilization Fund (PSF). We review the actions taken by the General Assembly, the impact of those actions on the TRF's fiscal condition, and examine the actuarial status of both the pre-1996 account (Closed Plan) and the 1996 account (New Plan) in the TRF. Finally, we will provide policy recommendations that will keep the state on the far-sighted and fiscally responsible road chosen by the Indiana General Assembly in 1989, 1993, and 1995.

The Indiana Fiscal Policy Institute, in December, 1988 produced a report entitled "Financing Teacher Retirement in Indiana," in which we called attention to the very serious unfunded liability of the TRF, which was then estimated at over \$3.4 billion. We identified policy options that incorporated a generally accepted public finance principle of recognizing the true current cost of pension benefits and not shifting those costs across generations. The principles underlying those options:

- The State of Indiana will recognize and meet its obligation to retired and subsequently retiring teachers.
- The State of Indiana will act to limit the impact on the General Fund budget by dedicating current resources to reduce the growth of the General Fund obligation from the New Plan.
- The State of Indiana will move, over time, from a "pay as you go" teachers' pension system to an actuarially sound and funded system that recognizes the true current cost of the teachers' retirement benefits.

In 1993, the General Assembly enacted legislation that closed the "old" teachers' pay-as-you-go pension plan and created an actuarially funded new plan in which all newly hired teachers would be members. Then, in 1995, the Pension Stabilization Fund was created. It would receive \$30 million annually, beginning in FY 1996, from the Lottery, \$25 million annually, beginning in FY 1996, from the General Fund, and \$425 million of employer reserves from the Old Plan. The legislation also limited increases in General Fund payments to 6% per year, beginning in FY 2006.

Estimates during the period prior to and during the 2003 budget-writing session of the General Assembly suggested that the PSF had accumulated greater funding than was necessary to meet its original obligations. These estimates ignored the increasing unfunded liability in the New Plan, which was a result of transfers from the Old Plan to the New Plan. Reacting to the severity of the recession's impact, the budget for fiscal years 2004 and 2005 called for \$190 million to be transferred each year from the PSF. In addition, the budget also stopped the deposit of \$30 million of Lottery proceeds into the PSF and used that money to subsidize employer contributions in the New Plan.

A total of 8,901 members have transferred from the Old Plan the New Plan since its inception. As of June 30, 2004, the unfunded liability of the New Plan totals \$683 million. To actuarially fund the New Plan, an actuarial determination of the employer contribution rate is done each year. The Teachers' Retirement Fund Board has consistently set the employer contribution rates lower than the actuarially determined rate necessary to fully fund the New Plan.

Since 1994, cost of living adjustments (COLAs) have been granted in every year except 2002, or 11 COLAs in the last 12 years, with actuarial funding of those COLAs occurring in only three of those years. Without advance funding, COLAs add to both the Old and the New Plan's unfunded liabilities. A prudent approach to long term TRF budget planning would include an assumption including some form of COLA. It is also worth noting that the impact on the retiree of not enacting COLAs is striking, over time. Assuming 2% inflation, retirees will lose eighteen percent of the purchasing power of the monthly pension benefit in the first 10 years and nearly 40% over 25 years.

Findings

1. Due to the actions of state policy makers, good investment returns, and the transfer of a portion of the unfunded liability from the Old Plan to the New Plan, analysis indicated that the Pension Stabilization Fund was, in six short years, in a fiscally sound enough position to meet the expectations set forth in the 1995 legislation creating it.
2. Due in part to transfers from the Old Plan to the New Plan, the estimated benefit payouts from the Old Plan have decreased over the last 8 years (from 1996 to 2004).
3. 8,901 TRF members have transferred from the Old Plan to the New Plan.
4. The cumulative impact of those 8,901 transfers is the development of \$683 million of unfunded liability in the New Plan.
5. Without changing recent and current practices, the Teachers' Retirement Fund's New Plan is in danger of developing an unfunded liability similar in scope to the Old Plan.
6. COLAs have been granted in 11 of the past 12 years, with those granted in eight of the years not being actuarially funded, thereby adding to unfunded liabilities in both the Old Plan and the New Plan.

Recommendations

1. Make no further dollar transfers from the Pension Stabilization Fund other than those set forth by the Pension Stabilization Percentage triggering mechanism.
2. Immediately, in fiscal year 2006, resume the transfer of \$30.0 million from Lottery proceeds to the Pension Stabilization Fund.
3. For budgeting and policy analysis purposes, actuarial estimates of future benefit payouts and unfunded liabilities should include an assumption of the granting of annual COLAs.
4. Permanently separate the Old Plan's unfunded liability from the New Plan by:
 - a. Stopping the transfer of members, and their accompanying unfunded liability, from the Old Plan to the New Plan and
 - b. Dedicating \$683 million of Pension Stabilization Fund assets to the New Plan, thereby eliminating the unfunded liability in the New Plan that is a result of transfers from the Old Plan (An alternative would move the transfers, and the associated unfunded liability, from the New Plan back to the Old Plan. Either would accomplish the same result).
5. Require that the Teachers' Retirement Fund Board set the employer contribution percentage for the New Plan at a level sufficient to cover all normal costs and COLAs.
6. Consider reducing the Pension Stabilization Percentage to 105%, which is more in line with recent revenue growth activity and with near term revenue forecasts.

Concluding Remarks

In order to continue on the road to prudent fiscal management of retired teacher pensions and the State's budget, the General Assembly must return to the original guiding principles that led to the sound public policy enacted nearly 10 years ago. Policymakers recognized then, and need to recognize now, that each

generation should shoulder the costs it incurs.

There is more at stake than whether teachers' will receive their pensions. Indiana must maintain its ability to provide adequate services to all Hoosiers and make necessary investments toward a future that has a variety of challenges and uncertainties. Our ability to do so depends on thoughtful, prudent fiscal management that does not pass the current generations' pension obligations to future generations of taxpayers.

Short term budgetary and political pressures often detour policies based on sound public finance principles. Policymakers should keep their hands on the wheel and their eyes on Indiana's future. Generations of Indiana's teachers and taxpayers are counting on it.

THE TEACHERS' RETIREMENT FUND'S PENSION STABILIZATION FUND A TRUST FUND INSURING INDIANA'S COMMITMENTS

This Indiana Fiscal Policy Institute Report reviews the current condition of the Teachers' Retirement Fund (TRF) and the Pension Stabilization Fund (PSF). In doing so, we will review the actions taken by the General Assembly, the impact of those actions on the TRF's fiscal condition, and examine the actuarial status of both the pre-1996 account (Closed Plan) and the 1996 account (New Plan) in the TRF¹. Finally, we will provide policy recommendations that, if implemented, will continue the far-sighted and fiscally responsible road chosen in 1989, 1993, and 1995 by the Indiana General Assembly.

Background

The Indiana Fiscal Policy Institute, in December, 1988 produced a report entitled "Financing Teacher Retirement in Indiana,"² in which we called attention to the very serious unfunded liability of the TRF, which was then estimated at over \$3.4 billion. Even more distressing was the increasing pressure a growing TRF liability would place on the State's General Fund budget over the next 20-30 years.

The Report's analysis estimated TRF benefit payouts would increase from \$199 million in fiscal year 1992 to \$1.686 billion in fiscal year 2017, a compound average annual increase of 8.9%. Over the longer term (particularly from the late 1970s through 2000), the State's General Fund revenue has grown at rates between 5% and 6%, so the impact of the TRF on other budget priorities would be substantial, with expenditures growing at a minimum of one and one-half times faster than the revenue stream that supports them.

¹ The Closed Plan includes those members who were hired before July 1, 1995 and have been continuously employed by the same board of education as they were on that date. The New Plan includes those hired after July 1, 1995 and those employed by a different board of education (school corporation) than the one by whom they were employed before July 1, 1995.

² Fiscal Policy Report No. 1 (December 1988), "Financing Teacher Retirement in Indiana." <http://www.indianafiscal.org/docs/Report1.pdf>

To maintain the integrity of the TRF and the State's budget, the Report recommended the State implement a policy of advance funding of the future liabilities of the Fund, identifying several policy options, including:

1. Freezing the unfunded liability by appropriating enough each year to cover the "interest" on the unfunded liability
2. Amortizing the unfunded accrued liability, which means providing funding to increase the assets in the fund that will, over an extended period of time (for example, 40 years) eliminate the unfunded accrued liability
3. Funding the "normal cost," or the value of the benefits attributable to current service³.

The first two of the above recommendations are relatively self-explanatory within the context of the TRF and relate primarily to the existing conditions. The third recommendation, however, addresses the future of the TRF and merits a brief discussion.

Employers incur costs from the employment of labor; employing teachers in schools is no exception. Those costs include wages and salaries, employee benefits such as health care, and taxes. Employers incur another cost when employee benefits include a retirement benefit, such as the TRF pension. However, since the TRF (prior to 1996) was a pay as you go system, those retirement benefit costs were not recognized—or paid—by employers at the time they were incurred. The State of Indiana, in effect, said to the schools: You do not have to recognize or incur this cost now; the State will pay for it when the bill comes due, which occurs in a future generation, when our children are the primary taxpayers.

³ Indiana Fiscal Policy Institute. Fiscal Policy Report No. 1 (December 1988), "Financing Teacher Retirement in Indiana" <http://www.indianafiscal.org/docs/Report1.pdf>

The last recommendation the IFPI made in 1988 is one of the most basic of public finance principles and concerns the undesirability of shifting costs across generations. We strongly suggested to the State that the total cost of employing teachers be recognized at the time that cost was incurred. That meant prefunding (or actuarially funding) the cost of the retirement benefits that were accruing to teachers. Prefunding is accomplished when employers pay the normal cost of retirement benefits attributable to the teacher's current service.

Therefore, the guiding principles behind those recommendations can be characterized as follows:

- The State of Indiana will recognize and meet its obligation to retired and subsequently retiring teachers;
- The State of Indiana will act to limit the impact on the General Fund budget by dedicating current resources to reduce the growth of the General Fund obligation from the Old Plan; and
- The State of Indiana will move, over time, from a "pay as you go" teachers' pension system to an actuarially sound and funded system that recognizes the true current cost of the teachers' retirement benefits.

A Looming Problem – A Farsighted Solution

In the 1989 Session, the General Assembly passed P.L. 341 – 1989(ss) which dedicated \$30.0 million from Lottery proceeds to reduce the growth of the Unfunded Actuarial Accrued Liability (UAAL or "unfunded liability"). Then, in Public Law 54 – 1993, they enacted legislation that closed the "old" teachers' pay-as-you-go pension plan (the pre-1996 account, or Old Plan). It also created a new plan (the 1996 account, or New Plan) in which all newly hired teachers would be members. The New Plan was intended to be actuarially funded by requiring school corporations to set aside a fixed percentage of payroll.

As the State recovered from the impact of the 1990-1991 recession, the General Assembly

passed and the Governor signed P.L. 340 – 1995, creating the Pension Stabilization Fund and thereby put into law a course of action that would partially pre-fund the unfunded liability in the TRF. The law:

1. Stated the General Assembly's intent "to stabilize the state's general fund teacher pension expenditures as a percentage of the general fund" over the remaining life of the Old Plan.⁴
2. Created the PSF⁵ to receive:
 - a. \$30 million annually, beginning in FY 1996, from the Lottery
 - b. \$25 million annually, beginning in FY 1996, from the General Fund
 - c. \$425 million of employer reserves from the pre-1996 plan⁶
3. Set a "pension stabilization percentage" at 106%, which limited increases in General Fund payments to 6% per year, with the remainder of the pension obligation being funded from the PSF, beginning in FY 2006⁷.

Experiencing growing revenue and increasing balances, the State appropriated an additional \$100 million in the 1998-1999 biennium and an additional \$200 million in the 2000-2001 biennium to the PSF.

Combined, the actions the state had taken appeared to have stabilized the liability faced by the general fund. As of June 30, 2002, the PSF balance was \$1,786.8 million.

Estimates during the period prior to and during the 2003 budget-writing session of the General Assembly suggested that the PSF had accumulated greater funding than was necessary to meet its original obligations. These estimates were based on the conditions as of the June 30, 2002 Actuarial Valuation, but ignored the impact of TRF member transfers from the Old Plan to the New Plan⁸.

⁴ IC 21-6.1-2-8, as added by P.L. 340-1995, SEC 103.

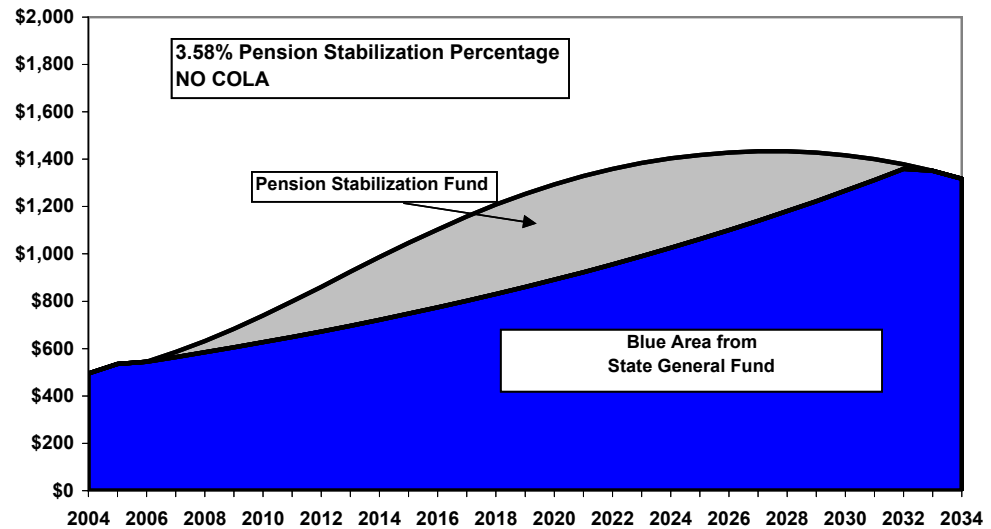
⁵ The Pension Stabilization Fund is somewhat of a misnomer, as it is effectively a sub-account within the Teachers' Retirement Fund. By law, and for accounting and administrative purposes, it is a part of the Employer Reserves within the Closed Plan account.

⁶ Indiana Fiscal Policy Institute. Fiscal Policy Brief (September, 1995), "An Update on Teacher Retirement Funding in Indiana" <http://www.indianafiscal.org/docs/Brief9-1995.pdf>

⁷ IC 21-6.1-2-8, as added by P.L. 340-1995, SEC 103.

⁸ See "The Report of the Annual Actuarial Valuation as of June 30, 2002 for the specific assumptions used at the time. This report is published by Gabriel, Roeder, Smith & Company annually. The Indiana Fiscal Policy Institute raised the issue of transfers at the

Figure 1.
Indiana Teachers' Retirement Fund
General Fund and Pension Stabilization Fund Contributions
FY 2004 - 2034 (June 30, 2002 Act. Valuation)
(millions of dollars)



Source: Indiana State Budget Agency, Indiana State Teachers' Retirement Fund, IFPI Calculations.

The annual Actuarial Valuation reports documented the impact of transfers, which manifested itself in the development of an unfunded liability in the New Plan. This omission significantly overstated the positive condition of the PSF, as we shall see in more detail below. Nevertheless, the stage was set for changes in the use of the PSF in the wake of the 2001 recession.

A Recessionary Budget Crisis and some “Creative” Budgeting

By the time the General Assembly began crafting the state budget for fiscal years 2004 and 2005 early in calendar year 2003, the 2001 recession had a dramatic impact on the State's fiscal status. Reacting to the severity of the recession's impact, the budget for fiscal years 2004 and 2005 called for transfers from the PSF. Those transfers would decrease the amount that would otherwise be paid by the General Fund by \$190 million in each year. In order to accomplish the transfer, the Budget Act changed the law enacted nearly a decade earlier⁹ to allow transfers from the PSF prior to fiscal year 2006, the year in which the first

transfers from the PSF were originally to be made.

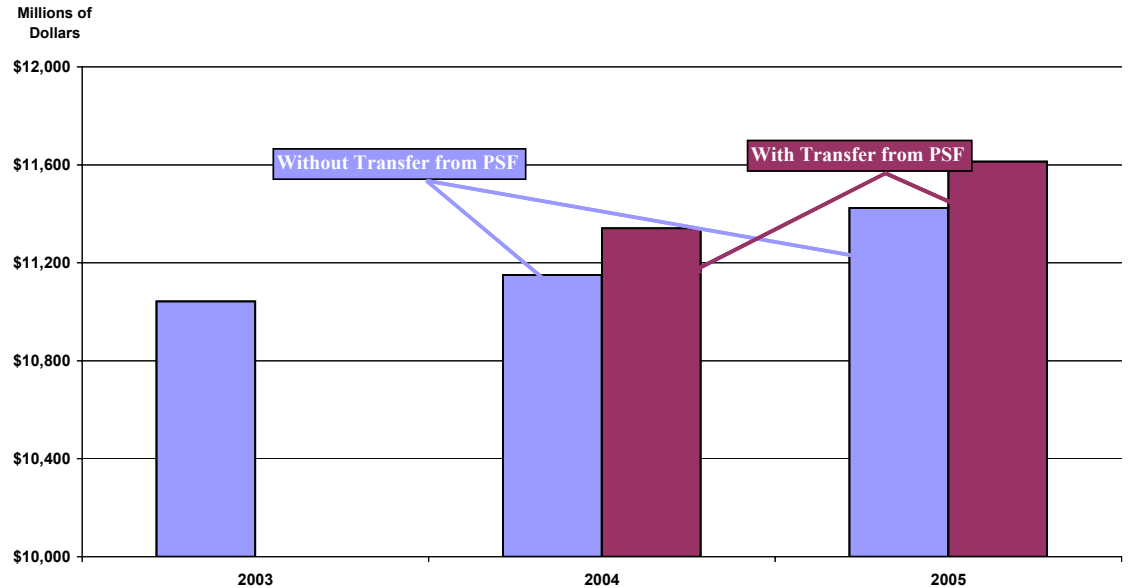
The transfers allowed all other General Fund Appropriations to be \$190 million per year higher than they would otherwise have been. In percentage terms, total appropriations were able to grow by 2.4% in fiscal year 2004 and by 4.1% in fiscal year 2005. Without the transfer, appropriations would have been able to increase by only 1.0% and 2.7% in each year.

The budget also stopped the deposit of \$30 million of Lottery proceeds into the PSF for fiscal years 2004 and 2005 and used that money to subsidize the employer contributions in the New Plan, as set by the TRF Board of Trustees. Most observers at the time agreed that, while unusual and unprecedented, these actions did not substantially reduce the long term viability of the PSF, as long as it was a “one-time” action.

The analysis of the PSF and the Old Plan supporting the actions in the budget for 2004-2005 were based on actuarial assumptions that produced a projected benefit payout

time and we have recreated the limited form of the analysis for use in this document.
9 P.L. 340 – 1995, Section 103.

Figure 2. Impact on General Fund Appropriations of Pension Stabilization Fund Transfers, Fiscal Years 2004 and 2005
(millions of dollars)



Source: Indiana State Budget Agency, IFPI Calculations.

stream for the Old Plan and the long term capability of the PSF. However, the analysis focused only impacts and projections regarding the Old Plan and did not include the impact of TRF members transferring from the Old Plan to the New Plan. The transfers produced two very important consequences. First, the benefit payout projections for the Old Plan were reduced. Second, the transfers were creating an unfunded liability in the New Plan.

Changing Estimates

While actuarial assumptions often change, the major reason for the reduction in benefit payout estimates was due to a single factor: all new hires were placed in the New Plan.

General Fund Annual Percentage Increases	2004	2005
Without Pension Stabilization Fund Transfer	1.00%	2.70%
With Pension Stabilization Fund Transfer	2.40%	4.10%

Source: Indiana State Budget Agency, IFPI Calculations.

That included those who “transferred” from one Indiana school corporation to another and had been in the Old Plan or those that had previously been in the Old Plan, stopped working, and after July 1, 1996, returned to work. In other words, all new hires that had been in the Old Plan were now included in actuarial projections of benefits in the New Plan. Since they were no longer members of the Old Plan, the benefit payout estimates were reduced in the Old Plan.

A significant amount of movement has occurred. A total of 8,901 members have transferred from the Old Plan the New Plan since its inception. Since they brought their benefit payout liability with them, an unfunded liability has developed in the New Plan. As of June 30, 2004, the unfunded liability totaled \$683 million¹⁰. On average, transfers from the Old Plan increased the unfunded liability in the New Plan by \$68.3 million each year since the creation of the New Plan. Of course, the unfunded liability in the Old Plan was being reduced by these transfers every year, as were the benefit payout estimates.

¹⁰ Table 2 denotes only the unfunded liability due to transfers, as estimated by the Actuary. As will be discussed later, the total net unfunded liability is slightly lower, due to the level of the employer contribution rate set by the Teachers' Retirement Fund Board.

Table 2.
The New (1996) TRF Plan
Development of Unfunded Liability
Due to Transfers From the Old Plan¹⁰
(millions of dollars)

Year	# of Transfers	UAL	Cumulative UAL
Other ¹	214	33.5	33.5
1996	810	68.5	102
1997	791	58.5	160.5
1998	828	69.5	230
1999	844	65.5	295.5
2000	1,242	85.5	381
2001	1,413	103.5	484.5
2002	1,046	79	563.5
2003	804	61.5	625
2004	<u>909</u>	<u>58</u>	683
Total	8,901	683	

¹ Transfers not attributable to a specific year

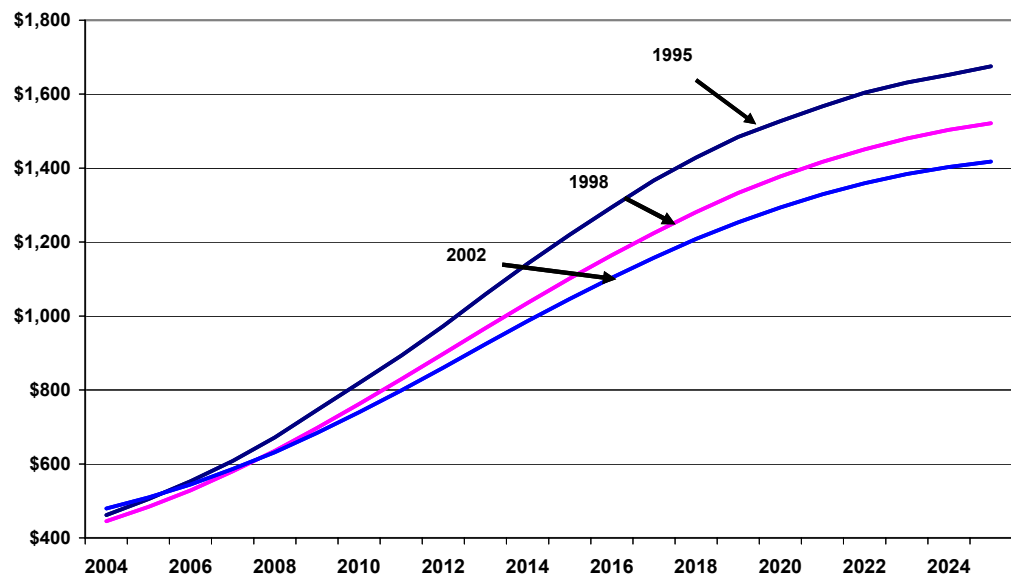
Source: Indiana State Teachers' Retirement Fund.

For purposes of projecting benefit payouts, the actuarial firm of Gabriel, Roeder, Smith & Co. (the Actuary) separates the Old Plan from the New Plan, because benefits for the Old Plan members are paid from the State General Fund and benefits for the New Plan are paid from the assets of the New Plan. As members of the Old Plan transferred to the New Plan, the State General Fund benefit payout projection fell, while the benefit payout projection from the New Plan increased.

As Figure 3 shows, this impact was significant in the Old Plan, with the General Fund obligation estimates falling by 10% to 15% in the years beyond 2010. In addition, Table 3 portrays the change in the annual rate at which lowered the benefit payouts would grow. Since the 1995 estimates, those rates had fallen from 9% to 10% per year to 7.5% to 8.5% per year.

Because the New Plan was supposed to be actuarially funded and there were no estimates of the impact of the transfers on the Old Plan, the reasons for the changed estimates were not immediately obvious. The only indication that something disconcerting was happening in the New Plan was the reporting, in the TRF

Figure 3. Total Estimated TRF (Old Plan) Annual Benefit Payouts 2004-2025
Comparison of June 30, 1995, 1995, and 2002 Actuarial Valuations
(billions of dollars)



Source: Indiana State Teachers' Retirement Fund.

Table 3. Comparison of Old Plan Benefit Payout Estimates

Fiscal Year	1995 Actuarial Valuation		2002 Actuarial Valuation	
	GF Obligation	Annual % Increase	GF Obligation	Annual % Increase
2006	\$553.60	9.70%	\$544.50	6.90%
2007	\$607.70	9.80%	\$586.20	7.70%
2008	\$671.50	10.50%	\$631.60	7.70%
2009	\$745.50	11.00%	\$683.40	8.20%
2010	\$818.50	9.80%	\$739.90	8.30%
2011	\$893.20	9.10%	\$799.10	8.00%
2012	\$973.00	8.90%	\$860.80	7.70%
2013	\$1,059.00	8.80%	\$924.20	7.40%
2014	\$1,141.90	7.80%	\$986.30	6.70%
2015	\$1,220.00	6.80%	\$1,046.00	6.10%
2016	\$1,294.60	6.10%	\$1,103.20	5.50%

Source: Indiana State Teachers' Retirement Fund

Actuarial Valuations, of the development of an unfunded liability.

Why an Actuarially Unsound New Plan?

Table 4 lists, for each year, the actuarial determination of the employer contribution rate to actuarially fund the New Plan¹¹. There are two components to the contribution rate. The first is the normal cost, which covers New Plan members for their service in the New Plan. The other is the "UAAL" rate¹² which, over time, amortizes the unfunded liability of transfers from the Old Plan and, to the extent necessary, prior year underfunding due to estimation error. For example, in 2002, the

¹¹ These estimates are based on a "No COLA" assumption. Any enactment of a cost of living adjustment (COLA) will increase the unfunded liability in the New Plan and increase the actuarially determined employer contribution rate.

¹² The unfunded liability is the present value of the stream of future benefits for which there are no assets in the plan. This amount can be amortized over a period of time (for TRF, the current amortization assumption period is 30 years) by making annual "payments" that will eventually cover the unfunded liability. The UAAL rate is the contribution percentage that will generate that annual payment stream.

actuarially determined normal cost was 7.53% and the UAAL rate was 1.97%. The total, actuarially sound employer contribution rate should have been set at 9.50%.

However, the Trustees of the TRF set the employer contribution rate that year at 9.0%, or 0.5% less than necessary to actuarially fund the plan.

The TRF Board consistently set the employer contribution rates lower than the actuarially determined rate.¹³ For 2004 and 2005, the employer contribution rate was reduced by diverting the \$30.0 million transfer from the Lottery. The diversion reduced the employer contribution rate from 9.0% to 6.82% for those two years. The employer percentage contribution rate set by the Trustees

Table 4. Historical Employer Contribution Rates - New Plan Comparison of Actuarial Valuation and TRF Board Set Rates

Valuation Date SFY June 30	Actuarial Valuation Required Contribution Rate	Normal Cost Rate	UAAL Rate	TRF Board Set Employer Percentage
1996	9.02%	7.66%	1.36%	8.50%
1997	9.12%	7.61%	1.51%	8.50%
1998	9.07%	7.61%	1.46%	8.50%
1999	9.28%	7.58%	1.70%	8.50%
2000	9.54%	7.61%	1.93%	8.50%
2001	9.32%	7.46%	1.86%	9.00%
2002	9.50%	7.53%	1.97%	9.00%
2003	8.29%	6.20%	2.09%	9.00%
2004	8.39%	6.14%	2.25%	6.82%

Source: Indiana State Teachers' Retirement Fund

of the TRF has fallen short of the actuarially determined rate by an average of about one half of one percent (0.5%) per year. This, of

¹³ In 2003, the actuarially determined rate was 8.29% and the TRF Board maintained the employer contribution rate at 9.0%, which it had been since 2000. In 2004 and 2005, the P.L. 224 – 2003, Section 41 diverted the \$30.0 million transfer from the Lottery to the PSF and directed that the funds be used to reduce the employer contribution rate. Accordingly, the TRF Board set the employer contribution rate in 2004 and 2005 to 6.82%.

course, means that the actuarial impact of transfers from the Old Plan (bringing an unfunded liability with them to the New Plan) has not been totally offset by employer contributions and has led to the development of an unfunded liability. In the June 30, 2004 Actuarial Valuation, the New Plan unfunded liability was estimated at \$610.7 million¹⁴. This compares with the unfunded liability in the Old Plan of \$7,782.9 million as of that same date. While the New Plan unfunded liability is not nearly the magnitude of the Closed Plan, it is nevertheless inconsistent with the intent of the 1993 legislation creating the New Plan.

Looking Ahead in the Old Plan and the New Plan

Since 1994, cost of living adjustments (COLAs) have been granted in every year except 2002, or 11 COLAs in the last 12 years. However, in only three of those years—1998, 1999, and 2000—were the COLAs advance funded. Advance funding refers to the General Assembly appropriating, at the time the COLA was enacted, sufficient money to actuarially fund the cost of the COLA over the life of the Old Plan. Without advance funding, COLAs have costs that must be appropriated in each subsequent budget and therefore add to the Old Plan's unfunded liability. In the New Plan, they will increase the estimated employer contribution rate to cover the increased costs. A prudent approach to long term budget planning, given the impact of the Old Plan on the State's General Fund, would include an assumption including some form of COLA. In addition, recent

¹⁴ This is the Net Total unfunded liability as estimated by the Actuary. It includes both the impact of transfers from the Old Plan and the impact of employer contributions and new members in the New Plan.

Table 5. Unfunded Liability History New Plan

<i>As of June 30</i>	<i>Computed Actuarial Accrued Liability</i>	<i>Valuation Assets</i>	<i>Unfunded Liability</i>	<i>Change in Unfunded Liability</i>
1996	48	21	27	
1997	176	72	104	77
1998	298	136	162	58
1999	498	240	258	96
2000	706	368	338	80
2001	828	447	381	43
2002	1,167	621	546	165
2003	1,392	826	567	21
2004	1,649	1,039	611	44

Source: Indiana State Teachers' Retirement Fund

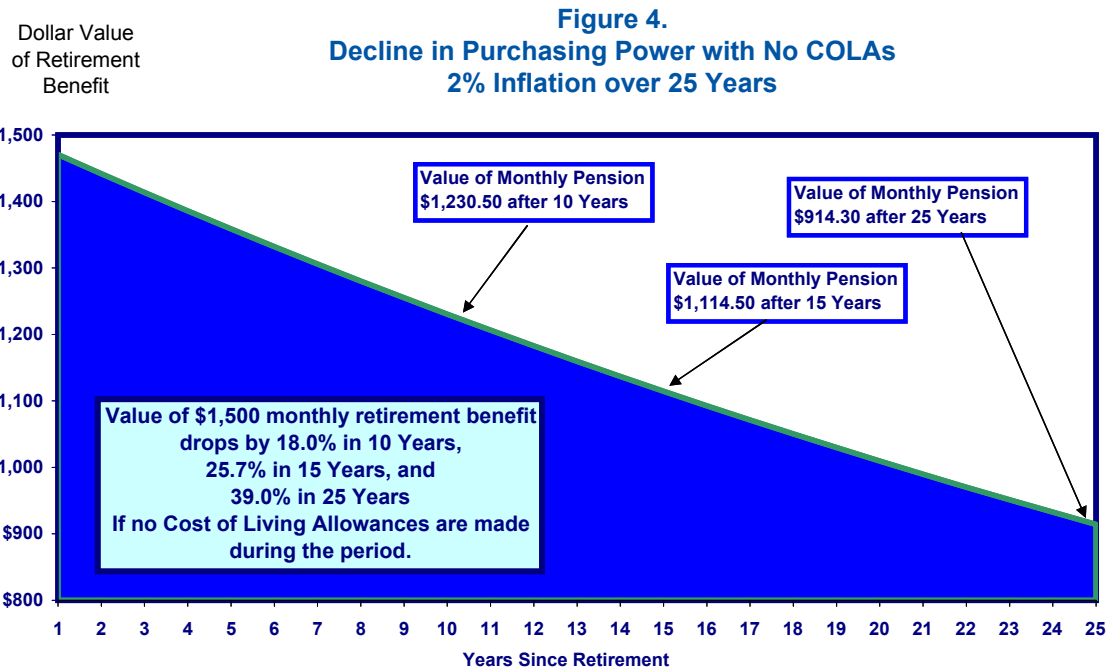
history of COLA enactment supports a COLA assumption. Finally, it is worth noting that the impact, on the retiree, of not enacting COLAs

Table 6. Teachers' Retirement Fund Old Plan State General Fund Obligations Annual 2% COLA - Fiscal Years 2005 through 2028

<i>Fiscal Year</i>	<i>Amount</i>	<i>Percent Increase</i>	<i>Fiscal Year</i>	<i>Amount</i>	<i>Percent Increase</i>
2005	\$519.4		2017	\$1,201.7	5.4%
2006	\$555.2	6.9%	2018	\$1,260.6	4.9%
2007	\$597.4	7.6%	2019	\$1,315.2	4.3%
2008	\$645.0	8.0%	2020	\$1,365.7	3.8%
2009	\$697.4	8.1%	2021	\$1,412.0	3.4%
2010	\$752.7	7.9%	2022	\$1,453.7	2.9%
2011	\$813.0	8.0%	2023	\$1,489.8	2.5%
2012	\$877.7	7.9%	2024	\$1,520.9	2.1%
2013	\$944.2	7.6%	2025	\$1,546.9	1.7%
2014	\$1,010.4	7.0%	2026	\$1,567.9	1.4%
2015	\$1,075.7	6.5%	2027	\$1,584.3	1.0%
2016	\$1,139.6	5.9%	2028	\$1,595.0	0.7%

Source: Indiana State Teachers' Retirement Fund

is striking, over time. Figure 4 illustrates the lost purchasing power experienced by a retiree over a 25 year period if no COLAs were



granted and if inflation averaged 2% over that period. Eighteen percent of the purchasing power of the monthly pension benefit is lost in the first 10 years and, by the time 25 years have passed, nearly 40% of the purchasing power is lost.

approximately \$1.6 billion and then fall as the number of retired members declines.

The COLA assumption makes a material difference in the projections. Without considering a COLA, the benefit Old Plan

The Actuary has provided a projection series for the next 50 years assuming the granting of a 2% (across the board) COLA every year, with no advance funding. The State General Fund's estimated benefits payout increases at annual rates from 7.0% to just over 8.0% through 2015, after which the annual percent increase begins to fall. Benefit payouts peak in 2029 at

Table 7. Teachers' Retirement Fund - New Plan
Comparison of Benefit Payout Projections
No COLA and With Annual 2% COLA

Year	No COLA	2% COLA	Percent Difference	Year	No COLA	2% COLA	Percent Difference
2005	15.0	15.0	0.0%	2018	115.5	127.4	10.3%
2006	17.2	17.3	0.6%	2019	130.4	144.6	10.9%
2007	20.1	20.4	1.5%	2020	146.6	163.4	11.5%
2008	23.6	24.2	2.5%	2021	163.9	183.6	12.0%
2009	27.9	29.0	3.9%	2022	182.4	205.4	12.6%
2010	33.0	34.7	5.2%	2023	202.8	229.3	13.1%
2011	39.3	41.6	5.9%	2024	225.1	255.7	13.6%
2012	46.6	49.8	6.9%	2025	249.9	284.8	14.0%
2013	55.2	59.3	7.4%	2026	277.9	317.6	14.3%
2014	65.1	70.3	8.0%	2027	310.0	354.9	14.5%
2015	76.1	82.6	8.5%	2028	346.8	397.6	14.6%
2016	88.1	96.2	9.2%	2029	388.6	445.8	14.7%
2017	101.3	111.2	9.8%	2030	435.8	500.1	14.8%

Source: Indiana State Teachers' Retirement Fund

Table 8. New Plan Projected Employer Contribution Rates - Assumes 2% COLA			
Year	Rate	Year	Rate
2005	7.33%	2016	7.26%
2006	7.33%	2017	7.26%
2007	7.32%	2018	7.25%
2008	7.32%	2019	7.25%
2009	7.31%	2020	7.24%
2010	7.31%	2021	7.23%
2011	7.30%	2022	7.23%
2012	7.30%	2023	7.22%
2013	7.29%	2024	7.22%
2014	7.28%	2025	7.22%
2015	7.27%	2026	7.22%

Source: Indiana State Teachers' Retirement Fund

The impact of assuming the enactment of an annual 2% COLA has a somewhat similar impact in the New Plan. By 2025, benefits that, in the case of the New Plan, will be drawn from employer reserves funded entirely by employer contributions will be 14% higher under the 2% COLA assumption. Using this assumption would increase the needed employer contribution rate versus using a no COLA assumption.

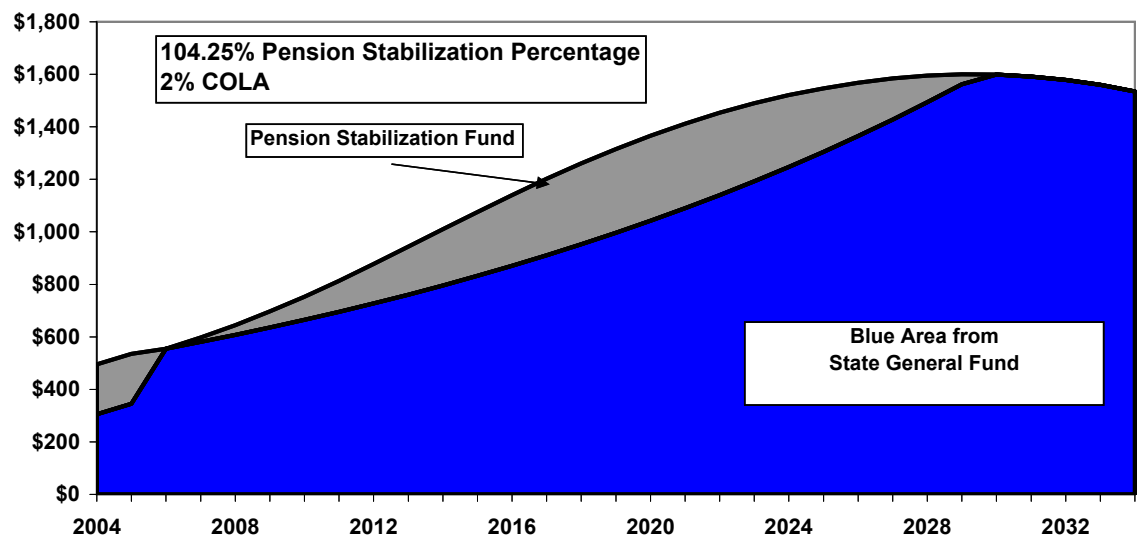
Employer contribution rates will be higher than normal cost in early years for the New Plan, projected at 7.33% in 2005 and 2006 and falling to 7.22% by 2026.¹⁵ In addition, there remains the \$683 million unfunded liability from transfers into the New Plan from the Old Plan.

The Condition of the Pension Stabilization Fund after the Recession

payout peaks at \$1,240.3 million in 2027, \$359.4 million less than with the COLA. The COLA assumption increases the payout assumption in that peak year by 29%.

The PSF's balance on June 30, 2004 was \$1,953.1 million. Using the Actuary's investment return assumption of 7.5% per year and assuming the transfer of the \$190.0 million at

**Figure 5. Indiana Teachers' Retirement Fund Old Plan
General Fund and Pension Stabilization Fund Contributions
FY 2004 - 2034 (June 30, 2004 Act. Valuation)
(millions of dollars)**



Source: Indiana State Budget Agency, Indiana State Teachers' Retirement Fund, IFPI Calculations.

¹⁵ Table 8 is based on an assumption that the \$683 UAAL from Old Plan transferees has been funded.

the beginning of the fiscal year provides an estimated balance of \$1,895.3 million at the end of fiscal year 2005. A legitimate question would be: Did the transfer of \$190 million from the PSF endanger the Fund's ability to provide protection to the General Fund budget as intended? The answer is a qualified no.

The qualification is that the \$30.0 million annual deposits from the Lottery resume in the 2006-2007 budget and that no further transfers from the PSF be made. If those conditions are met, the PSF could support a pension stabilization percentage¹⁶ of 104.25% (see figure 5) and, over the period from 2004 through 2031, contribute a total of \$6.104 billion to pension benefit payouts.

However, this does not address in any way the impact on the New Plan of the transfers from the Old Plan. As stated above, the unfunded liability in the new plan attributable to the transfers, as of June 30, 2004, is \$682.8 million.

Findings

1. Due to the actions of state policy makers, good investment returns, and the transfer of a portion of the unfunded liability from the Old Plan to the New Plan, analysis indicated that the PSF was, in six short years, in a fiscally sound enough position to meet the expectations set forth in the 1995 legislation creating it.
2. Due in part to transfers from the Old Plan to the New Plan, the estimated benefit payouts from the Old Plan have decreased over the last 8 years (from 1996 to 2004).
3. 8,901 TRF members have transferred from the Old Plan to the New Plan.
4. The cumulative impact of those 8,901 transfers is the development of \$683 million of unfunded liability in the New Plan.
5. Without changing recent and current practices, the TRF's New Plan is in danger of developing an unfunded liability similar in scope to the Old Plan.

¹⁶ IC 21-6.1-2-8, as added by P.L. 340-1995, SEC 103 set the pension stabilization percentage at 106%.

6. COLAs have been granted in 11 of the past 12 years, with those granted in eight of the years not being actuarially funded, thereby adding to unfunded liabilities in both the Old Plan and the New Plan.

Maintaining the Integrity of the Teachers' Retirement Fund

The guiding principles that led to the creation of both the PSF and the New Plan can be characterized as follows:

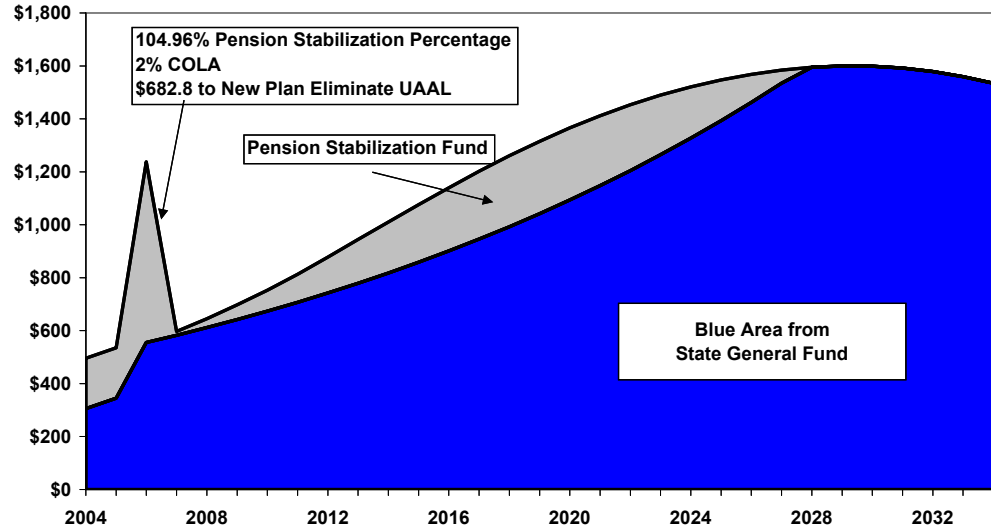
- The State of Indiana will recognize and meet its obligation to retired and subsequently retiring teachers.
- The State of Indiana will act to limit the impact on the General Fund budget by dedicating current resources to reduce the growth of the General Fund obligation from the New Plan.
- The State of Indiana will move, over time, from a "pay as you go" teachers' pension system to an actuarially sound and funded system that recognizes the true current cost of the teachers' retirement benefits.

To maintain the integrity of the TRF, the PSF, and their underlying principles, any analysis or proposals to modify any aspect of the TRF by the General Assembly should consider both the Old Plan and the New Plan. In addition, any analysis or recommendations should incorporate the assumption that COLAs will be granted, but not funded, as has been the recent practice.

Recommendations

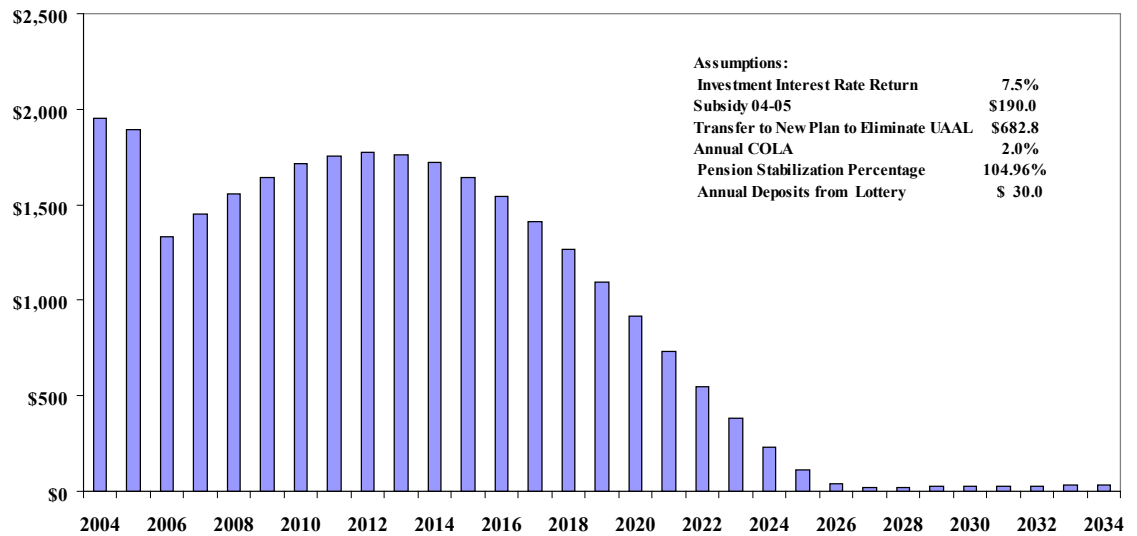
1. Make no further dollar transfers from the PSF other than those set forth by the Pension Stabilization Percentage triggering mechanism.
2. Immediately, in fiscal year 2006, resume the transfer of \$30.0 million from Lottery proceeds to the PSF.
3. For budgeting and policy analysis purposes, actuarial estimates of future benefit payouts and unfunded liabilities should include an assumption of the granting of annual COLAs.

**Figure 6. Indiana Teachers' Retirement Fund
General Fund and Pension Stabilization Fund Contributions
FY 2004 - 2034 (June 30, 2004 Act. Valuation)**
(millions of dollars)



Source: Indiana State Budget Agency, Indiana State Teachers' Retirement Fund, IFPI Calculations.

**Figure 7. Pension Stabilization Fund Balance
Fiscal Years 2004 - 2034
June 30, 2004 Act. Valuation, 2% COLA**



Source: Indiana State Budget Agency, Indiana State Teachers' Retirement Fund, IFPI Calculations.

4. Permanently separate the Old Plan's unfunded liability from the New Plan by:
 - a. Stopping the transfer of members, and their accompanying unfunded liability, from the Old Plan to the New Plan, and
 - b. Dedicating \$683 million of PSF assets
5. Require that the TRF Board set the employer contribution percentage for the New Plan at a level sufficient to cover all to the New Plan, thereby eliminating the unfunded liability in the New Plan that is a result of transfers from the Old Plan

normal costs and COLAs.

6. Consider reducing the Pension Stabilization Percentage to 105%, which is more in line with recent revenue growth activity and with near term revenue forecasts.

Indiana Fiscal Policy Institute analysis shows that the PSF can support a Pension Stabilization Percentage of 104.96% and transfer \$682.8 million of assets to eliminate the UAAL in the New Plan. The General Fund TRF liability grows at 4.96% or less until the peak of benefit payouts are reached in 2029, at which point the General Fund appropriations will begin to decline.

The PSF balance approaches zero as the peak is reached, with the last transfer from the Fund occurring around 2027, leaving a small balance of less than \$30.0 million. At that time, the transfer from Lottery proceeds could stop and those funds used for another purpose.

Concluding Remarks

Actions by the General Assembly in 1989, 1993, and 1995 implemented a policy that:

- recognized the State's pension obligations to its teachers and made the commitment to meet those obligations;
- limited the impact of a grossly underfunded pension plan on the General Fund by dedicating current resources to reduce the State's future General Fund obligations;
- created a new, actuarially sound pension plan for all teachers hired after January 1, 1996; and
- moved deliberately to close, over the next few decades, the old, pay-as-you-go pension plan.

Despite the good work reating and implementing this plan over the past 15 years, the State is at a crossroads. Economic and political pressure led to:

- an early and unplanned tapping of \$380 million from the PSF

- discontinuing the transfer of current resources from the Lottery into the PSF; and
- the development of a significant and growing unfunded liability in the New Plan because employer contribution rates were not set sufficient to offset the effect of transfers from the Old Plan, who brought with them their unfunded liability from the Old Plan.

In order to continue on the road to prudent fiscal management of retired teacher pensions and the State's budget, the General Assembly must return to the original guiding principles that led to the sound public policy enacted nearly 10 years ago. Policymakers recognized then, and need to recognize now, that each generation should shoulder the costs it incurs.

There is more at stake than whether teachers' will receive their pensions. Indiana must maintain its ability to provide adequate services to all Hoosiers and make necessary investments toward a future that has a variety of challenges and uncertainties. Our ability to do so depends on thoughtful, prudent fiscal management that does not pass the current generations' pension obligations to future generations of taxpayers.

Short term budgetary and political pressures often detour policies based on sound public finance principles. Policymakers should keep their hands on the wheel and their eyes on Indiana's future. Generations of Indiana's teachers and taxpayers are counting on it.

Copies of this report can be obtained on the IFPI's website – www.indianafiscal.org or by contacting our office.