Members of the Legislative Audit Committee:

In our audit report dated November 18, 2008, we concluded that the Employees Retirement System’s (System) basic financial statements for fiscal year 2008 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards. Our procedures identified a material weakness in internal control over financial reporting that could have materially affected the financial statements. Specifically, the System made a death benefit payment for a commissioned peace officer from the wrong fund. This payment was appropriate, but it was made from the wrong fund. Statement No. 34 of the Governmental Accounting Standards Board - Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments (GASB 34) required that the particular fund affected by this error be classified as a “major” fund; therefore, auditors identified this error as a material weakness in the System’s control structure.

It is important to note that the error described above totaled $250,000, but the System paid a total of $2.1 billion in benefit payments during fiscal year 2008. In addition, after auditors brought this error to the System’s attention, the System corrected it and properly recorded and reported the payment. The System made the error prior to its implementation of a new process based on a prior year audit recommendation to identify payments made from the wrong fund. All payments the System made after it implemented the new process were properly posted to the System’s general ledger.

Auditors did not identify any instances of non-compliance with laws or regulations that would materially affect the financial statements. However, auditors identified the following issues:

- As of August 31, 2008, the System held securities lending collateral that did not represent 100 percent of the value of the loaned securities. Texas Government Code, Section 815.303, requires the amount of securities lending collateral to be at least 100 percent of the amount loaned. As of August 31, 2008, the System held collateral for certain securities that was valued at $63,829 less than the $252.2 million in collateral required by state law.
The System incorrectly reported in its financial statements the types and amounts of securities lending non-cash collateral held as of August 31, 2008.

As of August 31, 2008, the System’s securities lending program may not have complied with state law because it accepted non-cash collateral, which included U.S. government agency securities, from borrowers in exchange for loaned securities. Based on Texas Government Code, Section 815.303, it is unclear whether U.S. government agency securities are approved collateral. Therefore, the System should obtain clarification regarding whether government agency securities can be accepted as collateral under statute.

However, our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations. With the exception of controls over death benefit payments for commissioned peace officers, the other major internal controls that we tested for the purpose of forming our opinion on the financial statements were generally operating effectively. We reported the material weakness and other less significant issues in accounting and financial reporting controls and information technology controls to System management in a separate letter.

As required by professional auditing standards, we will also communicate to the Audit Committee of the System’s Board of Trustees certain matters related to the conduct of a financial statement audit.

Conducting our audit of the System’s financial statements enabled us to obtain information on the actuarial funding status of the pension plan and retiree health care plan. That information is summarized below.

**Pension Plan Financial Highlights and Actuarial Funding Status**

The plans managed by the System had an unfunded actuarial accrued liability (UAAL, which represents the deficit of the plans’ actuarial assets compared with their actuarial liabilities) of $2.0 billion as of August 31, 2008. That amount includes unfunded actuarial accrued liabilities of $1.9 billion for the Employees Retirement System (ERS) plan, $67.6 million for the Law Enforcement and Custodial Officers’ Supplemental Retirement Fund (LECOSRF) plan, and $6.2 million for the Judicial Retirement System II (JRS II) plan.

The pension plans’ overall funding position decreased during fiscal year 2008. The plans’ investments earned negative 4.58 percent during fiscal year 2008, which is well below the 8.00 percent assumed long-term rate of return used for actuarial valuation purposes. This drove the combined funded ratio for the plans to be 94.0 percent as of August 31, 2008, which was a decrease from the previous year’s combined funded ratio of 95.7 percent. The funded ratio for the ERS pension plan was 92.6 percent; the funded ratio for the LECOSRF plan was 92.0 percent; and the funded ratio for the JRS II plan was 97.4 percent.

As of August 31, 2008, the combined pension plans’ net assets exceeded $22.4 billion. The combined pension plans paid $2.1 billion in benefit payments in fiscal year 2008. As of that same date, the rate of annual required contribution (ARC) of the State for fiscal year 2008 (the contribution rate that is needed to eliminate the actuarial funding deficit within the next 31 years) was 15.45 percent for the ERS plan and 2.51 percent for the LECOSRF plan.
The JRS II plan is actuarially sound based on a contribution rate of 22.83 percent. According to calculations made by the System’s actuary, the current total annual contribution rate of 12.45 percent of pay for the ERS plan (6.45 percent from the State and 6.00 percent from active members) and 1.59 percent for the LECOSRF plan is not sufficient to amortize the current UAAL over 30 years. A 30-year amortization period is important because state law prohibits making certain changes to the pension plan, such as increasing benefits, if (1) the amortization period is 31 or more years or (2) the changes would increase the amortization period to 31 or more years (see Texas Government Code, Section 821.006).

Based on discussions with auditors, the System added a subsequent event note to its fiscal year 2008 financial statements to document the decreased valuation of its assets after the balance sheet date of August 31, 2008, due to the current volatility in the capital markets. The System’s net assets under management as of August 31, 2008, totaled $22.2 billion. Net assets under management as of November 13, 2008, totaled $17.2 billion, a decrease of $5.0 billion.

Retiree Health Care Plan and Actuarial Funding Status

In accordance with Statement No. 43 of the Governmental Accounting Standards Board - Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans (GASB 43), the initial actuarial valuation of the retiree health care plan disclosed the following as of August 31, 2008:

- The unfunded actuarial accrued liability was $20.1 billion. The plan’s funded ratio (actuarial assets/actuarial liabilities) was zero because the plan is funded on a pay-as-you-go basis, with no assets set aside for future payments.

- The actuarially determined annual required contribution (ARC, or the annual contribution rate that would be sufficient to eliminate the unfunded actuarial accrued liability within the next 30 years) from employers and other contributing entities for fiscal year 2008 was $1.8 billion. This represents 19.4 percent of the related $9.3 billion payroll. However, the plan has historically been funded on a pay-as-you-go basis (contribution rates are intended to be sufficient to meet the current year’s health care costs), rather than being funded on an actuarially determined basis.

- The actuarial assumed rate of return on plan investments, which include both short-term and long-term investments, was 5.5 percent.
We appreciate the System’s cooperation during this audit. If you have any questions, please contact Michael C. Apperley, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

cc:   Members of the Employees Retirement System Board of Trustees
      Ms. Yolanda Griego, Vice Chair
      Ms. Cydney Donnell
      Mr. Don Green
      Mr. I. Craig Hester
      Mr. Owen Whitworth, CPA, CIA
      Mr. Donald Wood
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