A Report
to the
Montana
Legislature

Financial-Compliance Audit

Teachers' Retirement System

For the Two Fiscal Years Ended June 30, 2012

January 2013

Legislative Audit Division

12-09A

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LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Angus Maciver

January 2013

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit of the Teachers' Retirement System (system), a component unit of the state of Montana, for the two fiscal years ended June 30, 2012. We reviewed financial transactions, performed tests of selected state laws, and analyzed the system's financial statements.

This report contains one recommendation regarding actuarial soundness of the system. Based on the July 1, 2012, actuarial valuation of the system, current contributions are not sufficient to fund the system on an actuarially sound basis. To be considered actuarially sound, the amortization of the Unfunded Actuarially Accrued Liability (UAAL) must not exceed 30 years. The July 1, 2012, valuation indicates the UAAL does not amortize.

The system's response to our audit is on page B-1. We thank the Executive Director and his staff for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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Figures and Tables

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Appointed and Administrative Officials

			Term Expires
Teachers' Retirement Board	Jeff Greenfield, Chair	Shepherd	July 2016
	Robert Pancich, Vice Chair	Great Falls	July 2014
	Scott Dubbs	Lewistown	July 2013
	Kari Peiffer	Kallispell	July 2017
	Marilyn Ryan	Missoula	July 2016
	James Turcotte (Through January 7, 2013)	Helena	July 2015

Administrative Officials	David L. Senn, Executive Director
	Tammy Rau, Deputy Executive Director
	Dan Gaughan, Accounting Manager

For additional information concerning the Teachers' Retirement System, contact:

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Montana Legislative Audit Division

Financial-Compliance Audit
Teachers' Retirement System
For the Two Fiscal Years Ended June 30, 2012

January 2013 | 12-09A | Report Summary

In fiscal year 2012, the Teachers' Retirement System (system) paid out $99.4 million more in benefits than it collected in contributions. During the audit period, the system's financial position decreased by $40 million because investment earnings did not cover the difference between the $152 million of contributions collected and $251 million in benefit payments.

Context

The Teachers' Retirement System is a component unit of the state of Montana. It was established in 1937. Currently all full-time members of the public teaching profession, except for eligible employees of the Montana University System hired after July 1, 1993, are required to be members of the system.

A six member board governs the system. The Executive Director and system personnel are responsible for the daily administration of the system. At June 30, 2012, the system had 18 full-time equivalent employees.

At July 1, 2012, the system had more than 18,300 active members and approximately 13,300 retirees or beneficiaries receiving benefits. The system had $2.9 billion of assets.

The Montana Constitution requires the Teachers' Retirement System to be funded on an actuarially sound basis. To be funded on an actuarially sound basis, the system must be able to amortize its unfunded liability in 30 years or less.

Results

The July 1, 2012, actuarial valuation indicated the system's unfunded liability does not amortize. In eight of the last nine valuations, the system's unfunded liability has not amortized within the 30 year requirement. Table 1 on page 3 shows the historic trend of the system's actuarial soundness.

We issued an unqualified opinion on the system's financial statements, and this report contains one recommendation related to the actuarial soundness of the system.

Recommendation Concurrence	
Concur	1
Partially Concur	0
Do Not Concur	0
Source: Agency audit response included in final report.	

For a complete copy of the report (12-09A) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at http://leg.mt.gov/audit

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Chapter I – Introduction

Introduction

We performed a financial-compliance audit of the Teachers' Retirement System (system) for the two fiscal years ended June 30, 2012. The objectives of our audit were to:

1. Determine if the system's financial statements present fairly, in all material respects, the financial position of the system and the results of operations for the two fiscal years ended June 30, 2012.
2. Obtain an understanding of the system's controls to the extent necessary to support our audit of the system's financial statements and, if appropriate, make recommendations for improvement in the internal and management controls of the system.
3. Determine if the system complied with applicable laws and regulations.
4. Determine the implementation status of the previous audit recommendation.

Our financial audit of the system's financial statements for the fiscal year ended June 30, 2011, was issued in a separate report (10-09B). The financial statements are prepared by system personnel from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustment. Adjustments are made to accurately present financial activity.

This report contains one recommendation regarding the actuarial soundness of the system.

Background

The system is a component unit of the state of Montana. A component unit is a legally separate organization for which the state of Montana is financially accountable. The system had 18,372 active working members and 12,738 terminated employees not yet receiving benefits at July 1, 2012. Approximately 13,363 retirees or their beneficiaries were receiving retirement, disability, or survivor benefits as of July 1, 2012.

A six-member board, appointed by the Governor for five-year terms, governs the system. In addition to providing oversight to system personnel, the board's responsibilities include:

- Establishing rules and regulations necessary for the proper administration and operation of the retirement system.
- Determining the eligibility of a person who is applying for membership in the system.

- Designating an actuary to provide consultation on the technical actuarial aspects of the retirement system.

The Executive Director and system personnel are responsible for the daily administration of the system. At June 30, 2012, 18 full-time equivalent (FTE) positions were authorized for the system. All full-time members of the public teaching profession, except for eligible employees of the Montana University System hired after July 1, 1993, are required by law to be members in the retirement system.

Prior Audit Recommendations

Our office performed the prior financial audit of the Teachers' Retirement System for the fiscal year ended June 30, 2011. The system was determined to be actuarially unsound and system personnel continue to work towards solutions as discussed on page 3.

Chapter II – Findings and Recommendations

Retirement System Not Actuarially Sound

The Teachers' Retirement System (system) continues to be insufficiently funded to meet the constitutional requirement of actuarially soundness.

Article VIII, Section 15, of the Constitution of the state of Montana, requires public retirement systems to be funded on an actuarially sound basis. To be actuarially sound, resources derived from contributions and investment returns must be sufficient to fund member benefits and maintain the amortization period of unfunded liabilities at a maximum period of 30 years.

The most recent actuarial valuation, performed as of July 1, 2012, indicates the system is not actuarially sound. Table 1 shows the actuarial soundness of the system for the last ten valuations.

Table 1
History of System Soundness

Valuation Date	Actuarially Sound	Amortization Period
July 1, 2002	Yes	23.4
July 1, 2004*	No	71.3
July 1, 2005	No	Does not amortize
July 1, 2006**	No	Does not amortize
July 1, 2007***	Yes	28.6
July 1, 2008	No	31.3
July 1, 2009	No	Does not amortize
July 1, 2010	No	49.5
July 1, 2011	No	71
July 1, 2012	No	Does not amortize

*Prior to 2004, valuations were performed every two years.

**Legislature appropriated $100 million from the General Fund. (Special Session Laws, 2005, Ch. 1)

***Legislature appropriated $50 million from the General Fund (Session Laws, 2007, Ch. 305)

Source: Compiled by the Legislative Audit Division.

To become actuarially sound changes need to occur either in the system's funding or benefit provisions, which are governed by statute, or the system's investment returns, which are subject to market volatility, need to consistently increase. System management is aware that these are the areas that can affect the soundness of the system and took the following steps to work towards actuarial soundness of the system.

The system's investments are spread across many different investment types to capitalize on potential investments gains and at the same time mitigate investment risk. During the last four legislative sessions, the Teachers' Retirement System Board (board) requested legislation affecting the system. Some of these proposals were enacted into law.

During the last fiscal year, management worked with various interim committees and talked to active and retired members, employers, union representatives, and the university system to determine system changes these stakeholders would support. Based on this information, the board requested legislation to increase employee and employer contribution rates, changing supplemental contributions by the university systems, and adding an additional General Fund contribution, which will cease when the system becomes sound. Additionally, the legislation proposes changes in system requirements for new hires, including increasing contribution rates, retirement age, and the length of time new hires must work before they can retire. System management stated these proposed changes will make the system actuarially sound upon passage. House Bill 90 and House Bill 112 have been proposed in the 2013 Legislative Session.

Recommendation #1

We recommend the Teachers' Retirement System continue to take necessary measures until the retirement system is funded on an actuarially sound basis as required by the Montana Constitution.

Independent Auditor's Report

LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Angus Maciver

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statement of Fiduciary Net Position of the Teachers' Retirement System as of June 30, 2012, and the related Statement of Changes in Fiduciary Net Position for the fiscal year then ended. The information contained in these financial statements is the responsibility of the system's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year partial comparative information has been derived from the system's 2011 financial statements and, in our report dated October 27, 2011, we expressed an unqualified opinion on the system's respective financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Teachers' Retirement System as of June 30, 2012, and its changes in net position for the fiscal year then ended, in conformity with accounting principles generally accepted in the United States of America.

The financial statements include partial prior-year comparative information. Such information does not include all of the required detail to constitute a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the system's financial statements for the fiscal year ended June 30, 2011, from which the partial information was derived.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on Page A-5, TRS Plan Schedule of Funding Progress on page A-18, TRS Plan Schedule of Contributions from Employers and Other Contributing Entities on page A-19, and Other Postemployment Benefit Plan Information Schedule of Funding Progress on page A-22 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures

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to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The Schedule of Administrative Expenses on page A-23, Schedule of Investment Expenses on page A-24, and Schedule of Payments to Consultants on page A-24 are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

At July 1, 2012, the Teachers' Retirement System was not actuarially sound. The amortization period for the Unfunded Actuarial Accrued Liability is infinite. The maximum allowable amortization period is 30 years.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor

December 21, 2012

Teachers' Retirement System
Management's Discussion and Analysis,
Financial Statements, Required Supplementary Information,
and Supplementary Information

TEACHERS' RETIREMENT SYSTEM
MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis provides an overview of the financial activity of the Montana Teachers' Retirement System (TRS) for the fiscal year ended June 30, 2012, with comparative totals for the fiscal years ended June 30, 2011 and 2010. Please read this in conjunction with the financial statements, accompanying footnotes, required supplementary information with notes, and supporting schedules.

Overview of the Financial Statements

Because of the long-term nature of a defined benefit pension plan, financial statements alone cannot provide sufficient information to properly reflect the System's ongoing plan perspective. The Statement of Fiduciary Net Position reflects the resources available to pay benefits to retirees and beneficiaries. The Statement of Changes in Fiduciary Net Position presents the changes that occurred in those resources for the fiscal year ended.

Financial Highlights

- The TRS fiduciary net position decreased by $40.2 million for 2012 and increased by $451.0 million for 2011, representing a decrease of 1.4% for 2012 and an increase of 17.9% for 2011.
- Net investment income (fair value of investments plus investment income less investment expense) decreased in 2012 by 87.7% and increased in 2011 by 82.7% representative of the market volatility from year to year.
- Pension benefits paid to retirees and beneficiaries increased 6.9% and 6.8% for the last two fiscal years respectively.

Condensed Financial Information (in millions)

Fiduciary Net Position	FY2012	FY2011	FY2010	2012 Percent Inc/(Dec)	2011 Percent Inc/(Dec)
Cash/Short-term Investments	$ 35.0	$ 48.9	$ 44.4	(28.4)	10.1
Receivables	22.2	23.2	24.0	(4.3)	(3.4)
Investments (fair value)	3,006.1	3,047.0	2,615.3	(1.3)	16.5
Other Assets (net)	0.1	0.2	0.3	(50.0)	(33.3)
Total Assets	3,063.4	3,119.3	2,684.0	(1.8)	16.2
Liabilities	131.2	146.8	162.5	(10.6)	(9.7)
Net Position	**$2,932.2**	**$2,972.4**	**$2,521.4**	**(1.4)**	**17.9**
Changes in Fiduciary Net Position					
Additions:					
Employer Contributions	$ 72.4	$ 72.9	$ 72.2	(0.7)	1.0
Plan Member Contributions	62.7	63.0	62.8	(0.5)	0.3
Other Contributions	16.8	17.4	17.2	(3.4)	1.2
Net Investment Income	66.3	539.0	295.0	(87.7)	82.7

Total Additions	218.4	692.4	447.3	(68.5)	54.8
Deductions:					
Benefit Payments	251.4	235.1	220.2	6.9	6.8
Withdrawals	5.3	4.4	4.2	20.5	4.8
Administrative Expenses	1.8	1.8	1.9	0.0	(5.3)
Total Deductions	258.6	241.4	226.3	7.1	6.7
Net Inc/(Dec) in Net Position	**$ (40.2)**	**$ 451.0**	**$ 221.0**	**(108.9)**	**104.1**

Financial Analysis

- The change from year-to-year in cash/short-term investments is due mostly to the change in the number of shares held, at a per share value of $1, in the Short Term Investment Pool.
- The decrease in receivables for 2011 represents a $0.8 million less in contributions due at fiscal year end. The decrease in 2012 reflects a $0.5 million less in contributions due and $.05 million less in investment interest due at fiscal year end.
- The increase in investments for 2011 represents the recovery in the economy and capital market conditions while the slight decrease for 2012 was indicative of the stagnant performance of the markets overall.
- The significant fluctuation in liabilities is primarily due to the security lending collateral activity conducted by the Montana Board of Investments.
- The dramatic increase in net investment income for 2011 was due to an overall increase in the market value of our investment holdings and the decrease for 2012 reflects the decline in the market value of our holdings at fiscal year end.
- The increase in benefit payments from year-to-year reflects an increase in the number of retirees and beneficiaries plus the 1.5% guaranteed annual benefit adjustment.

Overview of the Actuarial Funding

The TRS plan experienced an asset gain over the last year. The market assets had a positive return of 2.21% net of investment and operating expenses. The actuarial assets earned 3.21% which is (4.54%) less than the actuarial assumption of 7.75%. Actuarial gains or losses result when the return on the actuarial value of assets differs from the actuarial investment return assumption. The following table compares the annual returns for the past three years.

Fiscal Year	Market Return	Actuarial Return	Actuarial Return over 7.75 %
7/1/2009 to 6/30/2010	12.87%	9.78%	2.03%
7/1/2010 to 6/30/2011	21.67%	(0.13)%	(7.88)%
7/1/2011 to 6/30/2012	2.21%	3.21%	(4.54)%

Contributions as a Percent of Pay

	Members	Employer Rate	State Contribution	Total
July 1, 2009 and after	7.15%	9.85%	0.11%	17.11%

The State's General Fund picked up the increase in the employer rate of 2.38% effective July 1, 2009 in lieu of the contributions being paid by the school district and community college employers.

Section 19-20-201, MCA, requires the actuarial report to show how market performance is affecting the actuarial funding of the Retirement System. The July 1, 2012 market value of assets is $80.2 million more than the actuarial value of assets. If the market value of assets was used, the amortization period would be 99 years, and the Funded Ratio would be 60.9%. Based on market assets, a contribution increase of 4.34% of pay (17.11% to 21.45%) effective July 1, 2013, is projected to maintain an amortization of the unfunded actuarial accrued liability over a 30 year period.

The valuation of assets on a current year basis differs from the actuarial valuation of assets as presented in the notes to the financial statements in that the actuarial valuation method spreads asset gains and losses over four years whereas all gains and losses are recognized in the current year as described above.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET POSITION
JUNE 30, 2012 AND 2011

	2012	2011
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note B)	$ 34,990,630	$ 48,885,812
Receivables:		
Accounts Receivable	18,239,103	18,726,665
Interest Receivable	3,943,728	4,462,165
Total Receivables	$ 22,182,831	$ 23,188,830
Investments, at fair value (Note B):		
Investment Pools	$ 2,875,013,588	$ 2,899,968,475
Other Investments	452,251	687,861
Securities Lending Collateral (Note B)	130,643,155	146,389,177
Total Investments	$ 3,006,108,994	$ 3,047,045,513
Assets Used in Plan Operations:		
Land and Buildings	$ 193,844	$ 193,844
Less: Accumulated Depreciation	(150,545)	(150,545)
Equipment	142,697	142,697
Less: Accumulated Depreciation	(91,521)	(70,489)
Prepaid Expense	0	6,401
Intangible Assets, net of amortization	13,603	28,443
Total Other Assets	$ 108,078	$ 150,351
TOTAL ASSETS	$ 3,063,390,533	$ 3,119,270,506
LIABILITIES		
Accounts Payable	$ 126,636	$ 86,396
Securities Lending Liability (Note B)	130,643,155	146,389,177
Compensated Absences (Note B)	178,869	180,541
OPEB Implicit Rate Subsidy (Note E)	239,397	193,342
TOTAL LIABILITIES	$ 131,188,057	$ 146,849,456
NET POSITION HELD IN TRUST FOR PENSION BENEFITS	$ 2,932,202,476	$ 2,972,421,050

The accompanying Notes to the Financial Statements are an integral part of this financial statement.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF CHANGES IN FIDUCIARY NET POSITION
FISCAL YEARS ENDED JUNE 30, 2012 AND 2011

	2012	2011
ADDITIONS		
Contributions:		
Employer	$ 72,422,404	$ 72,879,950
Plan Member	62,745,441	62,993,192
Other	16,843,766	17,437,366
Total Contributions	$ 152,011,611	$ 153,310,508
Misc Income	$ 9,689	$ 16,539
Investment Income:		
Net Appreciation/(Depreciation) in Fair Value of Investments	$ (8,013,031)	$ 455,020,967
Investment Earnings	89,331,577	99,119,730
Security Lending Income (Note B)	1,177,164	1,200,925
Investment Income/(Loss)	$ 82,495,710	$ 555,341,622
Less: Investment Expense	15,891,193	15,978,901
Less: Security Lending Expense (Note B)	263,225	334,365
Net Investment Income/(Loss)	$ 66,341,292	$ 539,028,356
Total Additions	$ 218,362,592	$ 692,355,403
DEDUCTIONS		
Benefit Payments	$ 251,410,455	$ 235,122,805
Withdrawals	5,294,856	4,364,713
Administrative Expense	1,829,800	1,843,368
OPEB Expenses (Note E)	46,055	49,187
Total Deductions	$ 258,581,166	$ 241,380,073
NET INCREASE (DECREASE) IN FIDUCIARY NET POSITION	**$** (40,218,574)	$ 450,975,330
NET POSITION HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	2,972,421,050	2,521,445,720
END OF YEAR	**$** 2,932,202,476	$ 2,972,421,050

The accompanying Notes to the Financial Statements are an integral part of this financial statement.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
NOTES TO THE FINANCIAL STATEMENTS
FISCAL YEARS ENDED JUNE 30, 2012 AND 2011

NOTE A. DESCRIPTION OF THE PLAN

The Teachers' Retirement Board is the governing body of a mandatory multiple-employer cost-sharing defined benefit pension plan, which provides retirement services to persons in Montana employed as teachers or professional staff of any public elementary or secondary school, community college, or unit of the university system. The system was established by the State of Montana in 1937 to provide retirement, death, and disability benefits and is governed by Title 19, chapter 20, of the MCA. TRS as an employer does not participate in the plan and acts only as the administrator of the plan.

At June 30, 2012, the number and type of reporting entities participating in the system were as follows:

Local School Districts & Coops	353
Community Colleges	3
University System Units	2
State Agencies	9
Total	367

At July 1, 2012, the date of the most recent actuarial valuation, system membership consisted of the following:

Retirees and Beneficiaries Currently Receiving Benefits	13,363
Terminated Employees:	
Vested	1,566
Non-vested	11,172
Current Active Members:	
Vested	11,934
Non-vested	6,438
Total Membership	44,473

The pension plan provides retirement, death, and disability benefits. Employees with a minimum of 25 years of service or who have reached age 60 with 5 years of service are eligible to receive an annual retirement benefit equal to creditable service years divided by 60 times the average final compensation. Final compensation is the average of the highest three consecutive years of earned compensation. Benefits fully vest after 5 years of creditable service. Vested employees may retire at or after age 50 and receive reduced retirement benefits. A Guaranteed Annual Benefit Adjustment (GABA) of 1.5% is payable each January if the retiree has received at least 36 monthly retirement benefit payments prior to January 1 of the year in which the adjustment is to be made.

NOTE B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The TRS, a discretely presented component unit Pension Trust Fund of the State of Montana financial reporting entity, prepares its financial statements using the accrual basis of accounting. Employee and employer contributions are recognized as revenues in the period when due pursuant to statutory requirements and investment income is recognized when earned. Benefit and withdrawal payments are recorded in the period in which the liabilities are due and payable.

Compensated Absences

Compensated absences represent 100 percent of accrued vacation and 25 percent of accrued sick leave for TRS personnel at June 30, 2012 and June 30, 2011.

Cash/Cash Equivalents and Investments

The Montana Board of Investments (BOI) manages the State's Unified Investment Program, which includes the TRS plan investments as required by Section 19-20-501, Montana Code Annotated. Per the Montana Constitution, Article VIII Section 13(3), investment of TRS assets shall be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims. Investments administered by the BOI for the TRS are subject to their investment risk policies. Information on investment policies, investment activity, investment management fees and a listing of specific investments owned by the pooled asset accounts can be obtained from Board of Investments at P.O. Box 200126, Helena, MT 59620-0126.

Information about the primary government's (State of Montana) investments, including credit risk classification, can be obtained from the Department of Administration, State Accounting Division, at P.O. Box 200102, Helena, MT 59620-0102.

Cash and cash equivalents consist of funds deposited in the State Treasurer's pooled cash account and cash invested in the Short-Term Investment Pool (STIP). Pooled investments other than STIP are reported at the fair value of each unit times the number of units owned. STIP is recorded at $1 per unit for each unit held. The fair value of publicly traded stocks and bonds is determined by reference to market prices supplied by State Street Bank (the custodial bank). Because a public market does not exist for private equity and real estate investments, the fair value of these investments is the value reported in the most recent external managers' valuation reports.

The TRS investments include: STIP; Retirement Funds Bond Pool (RFBP); Montana Domestic Equity Pool (MDEP); Montana International Equity Pool (MTIP); Montana Private Equity Pool (MPEP), Montana Real Estate Pool (MTRP). Other Investments consist of a portfolio of Structured Investment Vehicles (SIVs) at June 30, 2012.

The TRS Investment Portfolio is listed below:

TRS Cash Equivalent and Investment Portfolio
June 30, 2012

Investment	Book Value	Fair Value
STIP	$ 27,437,649	$ 27,437,649
RFBP	648,763,551	722,417,757
MDEP	465,392,294	1,078,537,745
MTIP	347,211,112	460,866,355
MPEP	221,446,781	379,889,785
MTRP	248,227,301	233,301,857
Other Asset Backed	452,251	452,251
Total	$ 1,958,930,939	$ 2,902,903,399

Securities Lending – Under the provisions of state statutes, BOI is authorized to lend its securities and has contracted with the custodial bank to lend the BOI securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The custodial bank is required to maintain collateral equal to 102 percent of the fair value of domestic securities and 105 percent of the fair value of international securities while the securities are on loan. The BOI and the custodial bank split the earnings, 80/20% respectively, on security lending activities. The BOI retains all rights and risks of ownership during the loan period. At June 30, 2012, the BOI had no credit risk exposure to borrowers. The private equity and real estate pools do not participate in securities lending. There were no failures by any borrowers to return or pay distributions thereon during the period that resulted in a declaration and notice of Default of the Borrower.

The investment risks for the pooled investments that TRS participates in are described in the following paragraphs.

<u>Credit Risk</u> – Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation.

<u>Custodial Credit Risk</u> - Custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the BOI may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

<u>Concentration of credit risk</u> – Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's investment in a single issuer.

<u>Foreign Currency Risk</u> – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. Currency exposures may be hedged, in a defensive manner, at the discretion of the active managers to preserve the U.S. dollar value of investments made. The managers are not allowed to engage in currency speculation, such as over-hedging, reverse hedging, cross-hedging or other trading activity not specifically aimed at minimizing risk versus their benchmark or preserving the U.S. dollar value of investments.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. In accordance with GASB Statement No. 40, the BOI selected the effective duration method to disclose interest rate risk. STIP interest rate risk is determined using the weighted average maturity (WAM) method.

All securities in pools are held in the name of the Montana BOI, or were registered in the nominee name for the Montana BOI and held in the possession of the BOI's custodial bank. MDEP, MTIP, MPEP, and MTRP do not invest in debt securities, so interest rate risk, credit risk, and concentration of credit risk do not apply to these holdings. According to GASB Statement No. 40, interest rate disclosures are not required for STIP since STIP is a 2a7-like pool. STIP, as an external investment pool, has not been rated.

The TRS investments subject to credit and interest rate risk at June 30, 2012 are categorized below:

Investment	Fair Value 6/30/12	Credit Quality Rating 6/30/12	Effective Duration 6/30/12	WAM in Days
RFBP	$ 722,417,757	A+	4.94	
STIP	27,437,649	NR		49

MPEP, MTRP, MTIP, and RFBP include assets subject to foreign currency risk. The MPEP and MTRP investments in EURO currency had a fair value of $35,247,883 at June 30, 2012. The MTIP and RFBP had cash and securities with a foreign currency value of $425,926,216 at June 30, 2012. The TRS position in those pools was approximately 37% at June 30, 2012.

NOTE C. CONTRIBUTIONS

The TRS funding policy provides for monthly employee and employer contributions at rates specified by state law. Plan members are currently required to contribute 7.15% of their earned compensation and the employer contribution rate for fiscal year 2012 was 9.85% of earned compensation. The State's General Fund contributed 2.38% of the employer contributions for school district and community college employers of their members earned compensation and an additional .11% of total earned compensation of all members. Each employer in the Montana university system shall contribute to the TRS a supplemental employer contribution currently at a rate of 4.72% of the total compensation of employees participating in the Optional Retirement Program (ORP). An actuary determines the actuarial implications of the funding requirement in annual actuarial valuations. The actuarial method used to determine the implications of the statutory funding level is the entry age actuarial cost method, with both normal cost and amortization of the accrued liability determined as a level percentage of payroll.

NOTE D. FUNDED STATUS and FUNDING PROGRESS

Our most recent actuarial valuation may be accessed on our website at: www.trs.mt.gov/Board/ActuarialValuations/ActuarialValuations.

The funded status of the TRS plan as of July 1, 2012, the most recent actuarial valuation date is as follows (dollar amounts in millions):

Actuarial Value of Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
$2,852.0	$4,814.7	$1,962.7	59.2%	$735.6	266.8%

The schedule of funding progress, presented as required supplementary information (RSI) following the notes to the financial statements, presents multiyear trend information about whether the actuarial values of plan assets are increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Valuation date	July 1, 2012
Actuarial cost method	Entry age
Amortization method	Level percent open
Remaining amortization period	Infinite
Asset valuation method	4-year smoothed market
Actuarial assumptions:	
Investment rate of return	7.75%
Projected salary increases	4.50%
Guaranteed annual benefit adjustment	1.50%
Inflation rate	3.50%

The actuarial valuation prepared as of July 1, 2012, the most recent valuation date, indicates the statutory rate is insufficient to fund the normal cost and to amortize the unfunded accrued liability under the entry age actuarial cost method over 30 years.

On a market value basis the TRS earned $345.0 million more than anticipated by the 7.75% assumption for the year ended June 30, 2011 and $161.8 million less than anticipated by the 7.75% assumption for the year ended June 30, 2012. The net result as of July 1, 2012 is that the market value of assets is $80.2 million more than the actuarial value of assets. This $80.2 million in unrecognized asset gains will cause the contributions needed to amortize the UAAL in future valuations to decrease. However, to remain financially sound in the future, TRS will need either (1) future gains such as asset returns greater than the 7.75% assumption, (2) an increase in contribution rates, (3) a reduction in liabilities, or some combination thereof.

NOTE E. OTHER POSTEMPLOYMENT BENEFITS

Plan Description

TRS employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration (MDOA). In accordance with Section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits for retirees and their dependents and beneficiaries that elect to continue coverage and pay administratively established premiums. Plan coverage is on a calendar year basis. For GASB 45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and TRS is considered to be a separate employer participating in the plan. Information about the State of Montana Other Postemployment Benefits (OPEB) can be obtained from the Department of Administration, State Accounting Division, at P.O. Box 200102, Helena, MT 59620-0102.

The plan allows retirees to participate, as a group, at a rate that does not cover all of the related costs. This results in the reporting of an "implied rate" subsidy in the related financial statements and footnotes. While this liability is disclosed for financial statement purposes, it does not represent a legal liability of the TRS.

Funding Policy

The contribution requirements of plan members are established and may be amended by the MDOA. The monthly premium for plan members ranges from $285 to $982 for calendar year 2011 depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental premiums vary between $34.90 and $59.36 and vision premiums vary between $7.64 and $22.26 depending on the coverage selected. The plan is financed on a pay-as-you-go basis.

Annual OPEB Cost

The annual required contribution (ARC), an actuarially determined rate in accordance with the parameters of GASB Statement No. 45, represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years.

Annual OPEB Cost

	TRS
Annual required contribution/OPEB cost	$ 37,838
Interest on net OPEB obligation	8,217
Annual OPEB cost	46,055
Contributions made	-
Increase in net OPEB obligation	46,055
Net OPEB obligation – beginning of year	193,342
Net OPEB obligation – end of year	239,397

The 2012 ARC is calculated for all the plan's employers and then allocated to each participating employer. The TRS 2012 ARC is $46,055 and is based on the plan's current ARC rate of 6.32% percent of total annual covered payroll for all employers. The 2012 ARC is equal to an annual amount required each year to fully fund the liability over 30 years. The amount of the estimated OPEB actuarial accrued liability was determined in accordance with GASB Statement 45, and the liability for TRS is estimated at $361,053. (The actuarial accrued liability is the present value of future retiree benefits and expenses.) For fiscal year 2012, the TRS allocated annual OPEB cost (expense) of $46,055 was equal to the ARC. The TRS annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2012 and the three preceding years were as follows:

Fiscal Year Ended		Annual OPEB Cost	% of Annual OPEB Cost Contributed		Net OPEB Obligation
6/30/2009	$	49,496	0%	$	96,974
6/30/2010		47,181	0%		144,155
6/30/2011		49,187	0%		193,342
6/30/2012		46,055	0%		239,397

Funded Status and Funding Progress

The funded status of the TRS allocation of the plan as of January 1, 2011, the most recent valuation date was as follows:

Actuarial accrued liability (AAL)	$361,053
Actuarial value of plan assets	$ 0
Unfunded actuarial accrued liability (UAAL)	$361,053
Funded ratio (actuarial value of plan assets/AAL)	0
TRS Covered payroll (active plan members)	$558,646
UAAL as a percentage of covered payroll	64.63%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. Actuarial calculations reflect a long-term perspective. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Projections of benefits for financial reporting progress are based on the substantive plan (the plan as understood by the employer and the plan members), and includes the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The projection of benefits for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

Actuarial Methods and Assumptions

As of January 1, 2011, the TRS actuarially accrued liability (AAL) for benefits was $361,053, with no actuarial value of assets, resulting in an unfunded actuarial accrued liability (UAAL) of $361,053, and the ratio of the UAAL to the covered payroll was 64.63%. The UAAL is being amortized as a level dollar amount over an open basis for 30 years.

In the January 1, 2011, actuarial valuation, the projected unit credit funding method was used for the State. The actuarial assumptions included a 4.25% discount rate and a 2.50% payroll growth rate. The projected annual healthcare cost trend rate is 10.0% for 2011 and decreases by 0.5% per year down to 5% for 2021 and beyond for medical and 10.0% for prescription drugs decreasing by 1% to 5% at 2016 and beyond.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
REQUIRED SUPPLEMENTARY INFORMATION

TRS PLAN
SCHEDULE OF FUNDING PROGRESS
(All dollar amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liabilities (AAL)[1]	Present Value of Future University Supplemental Contributions	Unfunded Actuarial Accrued Liabilities (UAAL)[2]	Funded Ratio[3]	Covered Payroll[4]	UAAL as a Percentage of Covered Payroll
July 1, 2007	3,006.2	3,928.5	153.4	768.9	79.6%	664.1	115.8%
July 1, 2008	3,159.1	4,110.8	157.1	794.6	79.9%	689.5	115.2%
July 1, 2009	2,762.2	4,331.0	157.2	1,411.6	66.2%	683.2	206.6%
July 1, 2010	2,956.6	4,518.2	158.7	1,561.6	65.4%	747.0	209.0%
July 1, 2011	2,866.5	4,658.6	155.1	1,792.1	61.5%	746.7	240.0%
July 1, 2012	2,852.0	4,814.7	152.4	1,962.7	59.2%	735.6	266.8%

(1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method. Effective July 1, 2010, the System's AAL includes the present value of future university supplemental contributions.

(2) Actuarial accrued liabilities less actuarial value of assets and present value of future university supplemental contributions. Effective July 1, 2010, the System's UAAL is not offset by the present value of future university supplemental contributions. Instead, the ORP contributions are used as additional contributions toward the System's amortization of the unfunded liability.

(3) Funded Ratio is the ratio of the actuarial value of assets over the actuarial accrued liabilities less the present value of future university supplemental contributions. Effective July 1, 2010, the System's UAAL is not offset by the present value of future university supplemental contributions. Instead, the ORP contributions are used as additional contributions toward the System's amortization of the unfunded liability.

(4) Covered Payroll includes compensation paid to all active employees on which contributions are calculated.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
REQUIRED SUPPLEMENTARY INFORMATION

TRS PLAN
SCHEDULE OF CONTRIBUTIONS FROM EMPLOYERS AND OTHER CONTRIBUTING ENTITIES

(All dollar amounts in thousands)

Fiscal Year Ended	Annual Required Contribution	Percentage Contributed
June 30, 2007	$ 96,228	117.1%
June 30, 2008	93,142	87.4%
June 30, 2009	80,998	100.0%
June 30, 2010	90,947	98.3%
June 30, 2011	91,859	98.3%
June 30, 2012	108,984	81.9%

A $50 million one-time contribution made by the State in FY 2007 is included in the calculation of the percentage of ARC contributed. Since the System is a Cost Sharing Multiple Employer Plan, there is no Net Pension Obligation (NPO).

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
NOTES TO THE REQUIRED SUPPLEMENTARY INFORMATION

Actuarial Cost Method

The actuarial valuation was prepared using the entry age actuarial cost method. Under this method, the actuarial present value of the projected benefits of each individual included in the valuation is allocated as a level percentage of the individual's projected compensation between entry age and assumed exit. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The normal cost was first calculated for each individual member. The normal cost rate is defined to equal the total of the individual normal costs, divided by the total pay rate.

The portion of this actuarial present value not provided for at a valuation date by the sum of (a) the actuarial value of the assets and (b) the actuarial present value of future normal costs is called the unfunded actuarial accrued liability. The unfunded actuarial accrued liability is amortized as a level percentage of the projected salaries of present and future members of the System.

The ultimate cost of any pension program over time equals the benefits paid and expenses incurred while administering the program. The source of revenue used to pay for this cost is equal to the contribution from employers and employees to fund the program, plus investment return earned on contributions made through pre-funding the benefit payments.

Valuation of Assets - Actuarial Basis

The actuarial asset valuation method spreads asset gains and losses over four years. The expected return is determined each year based on the beginning of year market value and actual cash flows during the year. Any difference between the expected market value return and the actual market value return is recognized evenly over a period of four years. The gains and losses are measured starting with the year ended June 30, 2007. The actuarial value of assets is not allowed to be greater than 120% or less than 80% of the market assets. (Adopted July 1, 2007)

Inflation Rate

The assumed inflation rate is 3.50% per annum, compounded annually (adopted July 1, 2004).

Investment Earnings

The annual rate of investment earnings of the assets of the System is assumed to be 7.75% per year, compounded annually. (Adopted July 1, 2004)

Guaranteed Annual Benefit Adjustment Increases

On January 1 of each year, the retirement allowance payable must be increased by 1.5% if the retiree's most recent retirement effective date is at least 36 months prior to January 1 of the year in which the adjustment is to be made.

Future Salaries
The rates of annual salary increases assumed for the purpose of the valuation include an assumed 4.5% annual rate of increase in the general wage level of the membership plus a variable merit and longevity rate from 0% to 4.51%. The merit and longevity increases for the Montana University System (MUS) members did not show a pattern of increasing or decreasing with service at the time of our most recent study. Therefore, the MUS members have a flat 1% merit and longevity assumption. The general wage increase assumption was adopted July 1, 2004 and the merit and longevity scales were adopted July 1, 2002.

MUS members are assumed to have a 0.63% higher average final compensation to account for the larger than average annual compensation increases observed in the years immediately preceding retirement.

Amortization Method
The unfunded actuarial accrued liability created by this method, including gains and losses, is amortized as a level percentage of the System's projected payroll.

Amortization Period
The amortization period of the unfunded actuarial liability over an open period is infinite as of July 1, 2012.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
REQUIRED SUPPLEMENTARY INFORMATION

Other Postemployment Benefits Plan Information
Schedule of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as % of covered Payroll ((b-a/c)
1/1/2007	-	$ 449,321	$ 449,321	0%	$ 519,969	86.41%
1/1/2009	-	357,664	357,664	0%	526,794	67.89%
1/1/2011	-	361,053	361,053	0%	558,646	64.63%

TEACHERS' RETIREMENT SYSTEM
NOTES TO THE REQUIRED SUPPLEMENTARY INFORMATION

Valuation date	January 1, 2011
Actuarial cost method	Projected unit credit funding
Amortization method	Level percent of payroll, open
Remaining amortization period	30 years
Asset valuation method	Not applicable since no assets meet the definition of plan assets under GASB 45
Actuarial assumptions:	
Projected salary increases	2.50%
Participation	
Future retirees	55.0%
Future eligible spouses	60.0%
Inflation rate	4.25%

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
SUPPORTING SCHEDULES
FISCAL YEARS ENDED JUNE 30, 2012 AND 2011

SCHEDULE OF ADMINISTRATIVE EXPENSES

Expenses for the administration of the plan, excluding compensated absences, depreciation and amortization, are budgeted and approved by the TRS Board. The administrative costs of the TRS are financed through realized investment income. The expenses, less amortization of intangible assets, may not exceed 1.5% of retirement benefits paid. Administrative expenses for the fiscal years ended June 30, 2012 and 2011 are outlined below:

	2012	2011
Budgeted Expenses:		
Personnel Services:		
Salaries	$ 834,304	$ 833,867
Other Compensation	3,400	3,150
Employee Benefits	272,248	264,087
Total Budgeted Personal Srvs	$ 1,109,952	$ 1,101,104
Operating Expenses:		
Contracted Services	$ 393,839	$ 373,821
Supplies & Material	20,788	57,394
Communications	106,937	60,050
Travel	26,912	17,635
Rent	48,872	61,051
Repair & Maintenance	15,799	11,182
Other Expenses	72,501	64,358
Total Budgeted Operating Exp	$ 685,648	$ 645,491
Non-Budgeted Expenses:		
Compensated Absences	$ (1,672)	$ (2,187)
Depreciation	21,032	21,032
Amortization of Intangible Assets	14,840	77,928
Total Non-Budgeted Expenses	$ 34,200	$ 96,773
Total Administrative Expenses	**$ 1,829,800**	**$ 1,843,368**

SCHEDULE OF INVESTMENT EXPENSES

Investment	BOI	Custodial Bank	External Managers	Total
STIP	$ 8,227	$ 3,246	$	$ 11,473
RFBP	235,828	79,196	564,931	879,955
MDEP	189,835	209,610	3,555,452	3,954,897
MTIP	196,973	58,123	1,359,439	1,614,535
MPEP	267,655	43,572	5,913,302	6,224,529
MTRP	189,142	25,646	2,991,016	3,205,804
	$ 1,087,660	**$ 419,393**	**$ 14,384,140**	**$ 15,891,193**

SCHEDULE OF PAYMENTS TO CONSULTANTS (included in administrative contracted services on previous page)

	2012	2011
Actuarial Services	$ 73,281	$ 102,231
Personnel Services	1,260	3,465
Legal Services	18,178	11,574
Medical Evaluations	1,484	275
Information Technology Services	112,650	77,700
Total Consultant Payments	**$ 206,853**	**$ 195,245**

Teachers' Retirement System

System's Response

TEACHERS' RETIREMENT SYSTEM

STEVE BULLOCK, GOVERNOR
www.trs.m

STATE OF MONTANA

1500 EAST SIXTH AVENUE
PO BOX 200139
HELENA, MONTANA 59620-0139

1-866-600-
406-444-

January 29, 2013

RECEIVED
JAN 29 2013
LEGISLATIVE AUDIT DIV.

Tori Hunthausen, Legislative Auditor
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

Dear Ms. Hunthausen:

Thank you for the opportunity to reply to the 2011-2012 financial-compliance audit report of the Teachers' Retirement System (TRS).

Recommendation # 1:
We recommend the Teachers' Retirement System continue to take necessary measures until the retirement system is funded on an actuarially sound basis as required by the Montana Constitution.

Response: Concur.

The ultimate decision on how to address TRS's unfunded liability rests with the Montana legislature, as only the legislature can set contribution and benefit rates. Prudent changes now can avert the need for more drastic measures later. The TRS Board has identified a number of corrective measures adopted by other states, and our actuaries have calculated the likely effects of implementing them here in Montana. At the request of the TRS Board, two bills are under consideration by the 2013 legislature, HB 90 and HB 112.

The fundamental equation for funding a retirement system is that benefits and administrative expenses must be provided for by contributions (past and future) and investment income. During fiscal year 2012, the System had contributions of $152.0 million and investment income of $66.3 million and benefits and administrative expenses of $258.6 million, resulting in a negative cash flow of $40.2 million. When a retirement system matures, benefits and administrative expenses often exceed contributions. In this case we say the system has a "negative cash flow." Mature systems are characterized by negative cash flows and large pools of assets. This is natural. Actuarial funding is designed to accumulate large pools of assets which will in turn provide investment income and finance negative cash flows when systems mature. If the fund is looked at as a whole, investment income is usually larger than the difference between contributions and benefit payments.

Tori Hunthausen, Legislative Auditor
January 29, 2013
Page 2

Unfortunately, the decline in the market value of assets following the recession of 2008-2009 has resulted in the need to increase funding and/or reduce liabilities. The Teachers' Retirement Board is committed to continue to work with the legislature, the Governor and all interested parties to pass legislation in 2013 that will actuarially fund the System.

Sincerely,

David L. Senn

David L. Senn
Executive Director
406-444-3376