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Updating Your Funding Strategy in the Face of New GASB Standards

Beginning in the 1970s, public pension plan sponsors began to increasingly prefund their plans, rather than paying benefits as they were due. This resulted in the need for pension plan funding policies. A funding policy states how to determine the amount that must be contributed to the pension each year to systematically fund the long-term cost of the promised benefits.

Since the mid-1990s, the annual required contribution (ARC) – as defined by the Governmental Accounting Standards Board (GASB) pension disclosure standards – has stood as a de facto funding standard. The ARC allowed for a choice among several actuarial cost methods and provided substantial flexibility with respect to the amortization of unfunded liabilities. Sponsors who made contributions at least as great as the ARC could avoid showing any debt associated with these plans on their balance sheets.

GASB has recently made significant changes to the pension disclosure standards for public plans. Plan accounting is now separated from funding, which has resulted in a vacuum for guidance on funding policies. Increased awareness surrounding this issue has led to the exploration and development of funding policy guidance by a variety of organizations related to public pensions. This Client Advisory provides an overview of funding policies, the considerations and components of establishing a policy, and recently issued and pending guidance.

FUNDING POLICY OVERVIEW

In order to meet the primary objective of a pension plan – paying promised benefits to members when due – it is vital that the plan has sufficient assets. The assets typically come from a mix of three sources: employer contributions, employee contributions and investment earnings. Plan sponsors are often limited in their ability to affect the employee contribution and investment earnings components. Ideally, the employer will be able to contribute an amount that is sufficient to fund the normal cost each year and amortize any unfunded pension liabilities over a reasonable period of time.

In addition to GASB eliminating the ARC, funding policies have come to prominence due to the growth in pension contributions as a component of state and municipal budgets and the impact of volatile plan asset returns on funding requirements. Two important considerations in developing a funding policy are the reasonable and equitable allocation of benefit costs over time and minimizing the volatility in the contribution rate.

GASB CHANGES

GASB establishes and maintains accounting and financial reporting standards for the US Government, including two statements related to public pension funds. Historically, the GASB ARC was used by many plan sponsors to determine the funding of public pensions plans. However, two new statements, Statements 67 and 68, were released in 2012 to replace the prior statements (25 and 27) and no longer require government employers to calculate an ARC in their financial reports.

While an ADC (Actuarially Determined Contribution) is presented in the Required Supplementary Information (RSI) of Statement 67, GASB provides no guidance on how this number is to be developed, and it is not expected to match the reported accounting cost. GASB has explicitly stated that the determination of an appropriate funding standard is outside of the scope of financial reporting. While GASB never had enforcement authority, the ARC in many cases stood in for a funding standard.

A full discussion of the GASB accounting changes is not within the scope of this advisory, but Cheiron has issued detailed information on this topic:

https://www.cheiron.us/cheironHome/viewArtAction.do?artID=94

ADDITIONAL INFLUENCES ON FUNDING POLICY

Many states and local jurisdictions have enacted legislation governing public pension benefit financing.

Actuaries are required to take into consideration Actuarial Standards of Practice (ASOPs), such as Statements 4 and 44, when providing professional advice to stakeholders in the course of developing a funding policy.

The financial markets, and in particular bond underwriters and the major credit ratings agencies, may also influence decisions regarding funding. Ratings agencies assess the credit quality of debt issuers and assign a grade that impacts borrowing costs for the issuer. For entities that sponsor pension plans and issue debt in the public finance markets, the funding of their sponsored pension plans is a factor in evaluating their credit risk.

All three major credit agencies, Moody's, Standard and Poor, and Fitch Ratings, are currently considering or have made changes to their methods used to evaluate and compare the health of public pension funds. For example, Moody's has recently adopted changes to their approach for analyzing state and local government pensions that includes the use of a long-term corporate bond index to adjust liabilities, the use of the market value of assets instead of a smoothed asset value, and the use of a 20-year amortization period for all amortization bases. These changes will result in the calculation of an adjusted net pension liability (ANPL) (computed by Moody's), distinct from the now-disconnected accounting numbers and funding numbers issued by the plans.

Additional guidance is also being developed by organizations of government officials and professional actuarial groups.

FUNDING POLICY OBJECTIVES

In developing a funding policy, several objectives should be considered, including:

- Assuring benefits can be paid when due;
- Considering intergenerational equity (i.e., ensuring taxpayers bear a burden commensurate with the services they receive);
- Sustainability and stability of contribution levels;
- Reviewing policy effects on the confidence level of the members that the benefits will be paid;
- Long-term feasibility of funding strategy; and
- Enforcement of the funding policy.

A well thought out and developed funding policy will result in many positive outcomes. In addition to providing guidance to decision-makers, it should create enhanced transparency to all stakeholders. This transparency results in increased confidence by the members in their benefit security, less risk to the taxpayers of unexpected costs, and more positive evaluations of the sponsors by the financial market participants, including rating agencies.

FUNDING POLICY COMPONENTS

Three primary components of a funding policy are typically identified: actuarial cost method, asset valuation method, and amortization methods. The actuarial cost method defines the procedures used to allocate the pension cost over the working life of an employee. The asset valuation methodology defines the method used to recognize pension asset gains and losses over a period of time, rather than in a single year, to reduce market volatility effects. The amortization methods define the length of time and structure of the payments (or credits) necessary to bring the level of assets to the level of the funding target, generally by paying down any unfunded accrued liability or gradual recognition of a surplus.

Actuarial Cost Method

While GASB historically allowed for the choice between six actuarial cost methods, the most commonly used method by public plans is the Entry Age Normal method, which typically allocates cost as a level percentage of payroll for benefits which are based on compensation. The new GASB standards will require the use of this method for accounting and disclosure purposes.

Asset Smoothing Method

The smoothing of assets using an asset valuation method contributes to the reduction of contribution volatility, as it reduces short-term market volatility effects. However, any method used should also track the overall market movements and be expected to approach the market value over the long-term.

One factor to be considered in developing the asset valuation method portion of a funding policy is the period over which market returns will be smoothed. In setting this policy, consideration should be given to the length of market cycles, the desired contribution stability level, the level of market volatility and the funded status, maturity, and benefit levels of the plan. The most commonly used period in public plans has been five years.

Another factor to be considered is whether the actuarial value of assets should be constricted to a corridor around market value, and if so, what size corridor is appropriate. Generally speaking, the longer the period over which returns are smoothed, the narrower the appropriate corridor will be. Hitting the corridor results in accelerated cost increases and inhibits smoothing, but this has been justified due to concerns about solvency, liquidity and other cash flow management factors.

Although the GASB ARC did not include any restrictions with respect to the selection of an asset smoothing method, the Actuarial Standards of Practice (in particular, ASOP 44) provide guidance to actuaries in the selection of appropriate asset valuation methods.

Amortization Methods

In developing the amortization component of a funding policy, different sources of the unfunded liability or surplus may be considered independently: experience gains/losses, assumption changes, and benefit changes. The appropriate amortization period – the timeframe over which unfunded liabilities are paid off or surplus is recognized – may vary based on the source of the change in the unfunded actuarial liability or the surplus. Typically, periods longer than the remaining service lives for actives or the expected average life expectancies for members no longer working should be considered with caution, as this may reduce generational equity. On the other hand, shorter periods will generally result in more volatile contributions.

Additionally, amortization polices can be constructed using fixed separate amortization periods (commonly referred to as layers) for each year's gain/loss and other liability change sources, or using a single amortization period. Layered approaches have some advantages over single period approaches with respect to transparency, since the component sources of the unfunded liability are tracked, and a specific date at which each source will be paid off can be identified. However, layered approaches can also result in additional contribution volatility due to elimination of layers (or bases) of different sizes in different years.

Many public plans also use an approach to amortization known as level percentage of payroll amortization, wherein the amount of the amortization payment is expected to increase each year as payroll increases. This approach will typically assist in the development of a cost that stays level as a percentage of payroll, a desired budgeting objective for many organizations. However, alternative approaches, such as level dollar amortization, wherein the amortization payment remains consistent each year as a dollar amount, may also be used.

In addition to setting the amortization periods and layers, there are other factors which should be considered in developing the amortization methods. First, there should be an explicit acknowledgement of the level and duration of negative amortization, if any. Negative amortization occurs when the interest payments on the unfunded liability are greater than the annual payments made on them initially, so that the unfunded liability actually grows in the early years. This will generally only occur when a level percentage of payroll approach is used, in combination with an amortization period longer than 16 or 17 years, depending on the actuarial assumptions. This consideration does not preclude the utilization of amortization methods that include negative amortization; it simply requires that this election be conscious.

Second, it may be reasonable to pursue different approaches towards amortization of an unfunded liability versus an asset surplus. The use of excessively long amortization periods for unfunded liabilities will pass these costs onto future generations, while the use of exceptionally short amortization periods for surplus have led to contribution holidays that have negatively affected the sponsor's ability to budget for increased pension contributions in future years. However, amortization policies are not the only tools available for managing pension plan surpluses.

Other Funding Methods

Not all funding methods are designed based solely on a framework defined by actuarial cost methods, asset smoothing methods and amortization methods. Some components of alternative financing strategies include direct smoothing of contribution rates, fixed-contribution rate methods, asset-liability based strategies, and even the use of stochastic or simulation-based methods. Although much of the recently-issued guidance does not address the development and evaluation of these alternative techniques, they may be considered in the development of a funding policy, with the advice of an actuary.

OPTIONS PROPOSED

While a number of groups are developing proposed guidance to address the dearth left by the GASB changes, two groups have already issued guidance: the "Big 7" and the California Actuarial Advisory Panel (CAAP). Other groups considering proposing guidelines include the Conference of Consulting Actuaries and the American Academy of Actuaries.

A pension funding task force developed by the "Big 7" state and local government associations[1], along with a few additional national groups of public sector government officials convened by the Center for State and Local Government Excellence, recently developed and released funding policy guidance[2].

They identified a number of key policy objectives for funding policies:

1. They should be based around an ADC;
2. Discipline should be included within the policy to assure payment;
3. They should strive to maintain intergenerational equity;
4. They should strive for stable employer contribution costs as a percentage of payroll; and
5. They should require clear reporting of how and when they will be funded.

Their report identified actuarial cost method, asset smoothing method, and amortization policy as the three most important parts of a funding policy. The actuarial cost method should be developed so the participants' benefits are fully funded by their

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[1]National Governors Association (NGA), National Conference of State Legislatures (NCSL), The Council of State Governments (CSG), National Association of Counties (NACo), National League of Cities (NLC), The U.S. Conference of Mayors (USCM), International City/County Management Association (ICMA), National Council on Teacher Retirement (NCTR), National Association of State Auditors, Comptrollers and Treasurers (NASACT), Government Finance Officers Association (GFOA), and National Association of State Retirement Administrators (NASRA)

[2]http://www.nga.org/files/live/sites/NGA/files/pdf/2013/1303PensionFundingGuideBrief.pdf

expected retirement and should be allocated based on a level percentage of compensation. They noted that the amortization policy is the key aspect for balancing the need for both intergenerational equity and contribution stability. They recommended that actuarial gains and losses, assumption changes, and plan changes should all be considered individually when developing the funding policy. Additionally, they noted that separate consideration should be given as to how surpluses should be managed. A final aspect of this report was mentioning the need for audits and reviews of the funding policy.

The Government Finance Officers Association (GFOA), which was a part of this task force, issued additional guidance related to the task force's findings. They provided clarification that a funding policy should be formally adopted with the goal of providing "reasonable assurance that the cost of [benefits] will be funded in an equitable and sustainable manner." Their guidance noted that the ADC should be obtained at least biennially and that employers should explicitly commit to fully fund the ADC each period, but also acknowledged the possible necessity for transition periods to achieve this goal. They also made clear that they will have guidance forthcoming about the specific components of funding policy as well as how employers should demonstrate accountability and transparency in communicating information about their funding progress for their sponsored pension plans.

The second group which has already issued guidance is the CAAP. The CAAP recently published "Actuarial Funding Policies and Practices for Public Pension and OPEB Plans and Level Cost Allocation Model"[3] which was adopted by the Panel on March 1, 2013. This document is advisory in nature and identifies elements and parameters of actuarial funding policy while also developing a Level Cost Allocation Model (LCAM), an internally consistent mathematical model to develop level costs that is suggested as a valid option for a funding policy.

The CAAP document considers possible practices in each of the policy elements and classifies them in one of five ways:

1. Model (LCAM consistent practices)
2. Acceptable practices
3. Acceptable practices, with conditions
4. Non-recommended practices
5. Unacceptable practices

It should be noted that CAAP explicitly does not equate model practices with best practices.

CAAP's advisory guidance also identified a set of goals for funding policies:

- Ensure that future contributions plus current assets will be sufficient to pay for all benefits expected to be paid to members and beneficiaries,
- Reasonably allocate benefit cost and required funding to years of service,
- Manage contribution volatility,
- Support accountability and transparency, by being clear both in intent and effect and providing for assessment mechanisms, and
- Provide tools to deal with the nature of plan governance, including agency risk issues.

Similar to the "Big 7" taskforce findings, the CAAP has noted that surplus should be considered separately from unfunded liabilities. In fact, the guidance says that amortization of UAAL and surplus should not be symmetrical. The CAAP guidance also generally favors fixed amortization layers over approaches which include rolling periods.

Both the Conference of Consulting Actuaries and the American Academy of Actuaries are considering guidance related to public pension funding policy, but nothing has been issued at this time.

[3] http://www.sco.ca.gov/Files-ARD/BudLeg/CAAP_Funding_Policies_w_letter.pdf

CONCLUSION

The importance of developing and making an actuarially determined contribution for public pension funds cannot be overstated. Most examples of serious funding problems in public plans are not the result of market events or unreasonable benefit changes but a result of the sponsor not making the required contributions.

Cheiron is a full-service actuarial consulting firm assisting Taft-Hartley, public sector and corporate plan sponsors manage their benefit plans proactively to achieve strategic objectives and satisfy the interests of plan participants and beneficiaries. To discuss how Cheiron can help you meet your technical and strategic needs, please contact your Cheiron consultant, or request to speak to one by emailing your request to ***info@cheiron.us****.*

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