

Benefits, Compensation and HR Consulting

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Actuarial Funding Policy Guidance: Comparison of Recommendations Reveals Considerable Consensus — and a Few Notable Differences

As readers of Segal Consulting's Public Sector Letters are well aware, the funding of U.S. public sector pension plans has become a high-profile topic in recent years. This has been due to many factors, including historically high volatility of investment returns, budgeting pressures experienced by the sponsoring entities, and increased scrutiny of plans that have not properly funded their pension obligations. Another important influence is that the Governmental Accounting Standards Board (GASB) has clarified that financial reporting standards do not constitute funding policy guidance, leaving something of a regulatory vacuum when it comes to public pension funding policies.

This is leading many public pension plans to review their existing funding policies and, for the first time in many cases, to record them in a comprehensive statement of funding

"GASB has clarified that financial reporting standards do not constitute funding policy guidance." policy used for setting an "actuarially determined contribution" (ADC). Organizations within the public pension industry (including three of the major professional actuarial groups) have responded to these developments by issuing guidance for establishing and maintaining actuarially responsible funding policies for these plans. While this effort is ongoing, we have seen the following guidance to date:

- > An October 2014 "White Paper" by the Conference of Consulting Actuaries Public Plans "Community" (the CCA PPC White Paper),¹
- ➤ A February 2014 Issue Brief published by the American Academy of Actuaries (the AAA Issue Brief),²
- ➤ A report published in February 2014 by an independent "Blue Ribbon Panel" commissioned by the Society of Actuaries (the BRP/SOA Report),³ and

IN THIS ISSUE:

- > Considerable Consensus
- ➤ Notable Differences
- **➤** Conclusion
- ➤ A March 2013 "Best Practice" published by the Government Finance Officers Association (GFOA) (the GFOA Best Practice).⁴

This *Public Sector Letter* discusses the similarities among these policy papers and points out notable differences.

CONSIDERABLE CONSENSUS

There is considerable consensus on the recommendations outlined in each of the reports and, for the most part, the suggested guidelines are in line with current actuarial practice in the public sector.⁵

Segal's November 2011 Public Sector Letter, "Planning a Successful Pension Funding Policy" (http://www.segalco.com/publications/publicsectorletters/nov2011.pdf), also addresses funding policy issues; the subsequent guidance is fully consistent with the policies developed and discussed in that publication.



¹ CCA PPC White Paper, "Actuarial Funding Policies and Practices for Public Pension Plans," is available from the CCA website: http://www.ccactuaries.org/publications/news/cca-ppc-white-paper.cfm. Note that the significant change from the CCA PPC's earlier "Discussion Draft" was to limit the scope of the guidance to pension plans rather than to also include OPEB plans.

² The AAA Issue Brief, "Objectives and Principles for Funding Public Sector Pension Plans," is available from the AAA website: http://www.actuary.org/files/Public-Plans IB-Funding-Policy 02-18-2014.pdf

³ The "Report of the Blue Ribbon Panel on Public Pension Plan Funding" is accessible from the SOA website: http://www.soa.org/blueribbonpanel

⁴ This GFOA Best Practice, "Core Elements of a Funding Policy," is available on the GFOA website: http://www.gfoa.org/core-elements-funding-policy. There are other relevant Best Practices (Guidelines for Funding Defined Benefit Pensions, Sustainable Funding Practices of Defined Benefit Pension Plans & Reviewing, Understanding and Using the Actuarial Valuation Report and Its Role in Plan Funding).

In comparing these reports, it is helpful to consider *Funding Policy Objectives* separately from *Specific Funding Policy Elements*.

Funding Policy Objectives

The greatest area of consensus among these reports is in the objectives of an actuarial funding policy. The most important policy objectives common to all the documents are that a public sector plan should be funded in accordance with an actuarially determined funding policy and that a plan's funding policy should target to fund 100 percent of the plan's actuarial liabilities over a reasonable period. There is also agreement among the recommendations that funding policy should be structured so that the annual contributions reasonably match the cost of benefits to the

years in which the benefits are earned, and that the contributions should be stable and predictable for budgeting purposes.

Table 1 highlights several of the key policy objectives common to two or more of the reports. Each report uses its own terms to describe these objectives, and the descriptions in Table 1 reflect a composite of those descriptions.

Table 1: Considerable Consensus on Funding Policy Objectives: How the Three Actuarial Organizations Compare to One Another and to the GFOA Best Practice

Objective	CCA PPC White Paper	AAA Issue Brief	BRP/SOA Report	GFOA Best Practice
Fund the expected cost of all promised benefits (<i>i.e.</i> , fund normal cost plus 100% of any unfunded actuarial liabilities).	✓	✓	✓	✓
Match annual contributions to fund the cost of benefits to years of service (i.e., target demographic matching or generational equity).	✓	✓	✓	✓
Have costs emerge stably and predictably (i.e., manage contribution volatility).	✓	✓	✓	✓
Balance competing funding- policy objectives.	√ ¹	✓	✓	✓
Identify risks ² that could make it difficult to achieve funding objectives.	✓	✓	✓	
Communicate how the funding-policy objectives will be achieved by the contribution allocation procedure (accountability and transparency).	✓	✓		√
Establish an enforcement mechanism for making contributions on a consistent, actuarially determined basis: actually fund the "actuarially determined contribution" (ADC).	√³	✓	✓	✓

¹ The CCA PPC White Paper talks specifically about a balance between targeting generational equity and managing contribution volatility.

² The CCA PPC White Paper focuses on agency risk, which refers to the possibility that interested parties (agents) may try to "influence cost calculations in directions viewed as consistent with their particular interests." The AAA Issue Brief also cites agency risk, but adds investment, demographic and "other" risks. The BRP/SOA Report focuses primarily on investment risk and related disclosures.

³ Although the CCA PPC White Paper does not mention an explicit enforcement mechanism, all of its guidance is developed under the presumption that the plan will be funded in accordance with its actuarial funding policy.

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Specific Funding Policy Elements

In addition to the general policy objectives discussed above, there is also significant agreement as to the specific funding policy elements of the actuarial cost method, asset smoothing and unfunded liability amortization. The Entry Age (sometimes called Entry Age Normal) actuarial cost method is recommended by the three reports that discuss specific funding policies: the CCA PPC White Paper, the BRP/SOA Report, and GFOA Best Practice.⁶ In addition, all three reports approve of asset smoothing for periods of five years. The reports are also consistent on approving the use of a level percent of pay method for amortization of unfunded liabilities.

Some areas where the documents differ are in the structure and length of amortization periods by source of unfunded liability, and the application of "market value corridors" (i.e., a corridor that constrains the difference between the smoothed value of assets and the market value) that should be included in the asset smoothing methodology. For asset smoothing, the CCA White Paper specifies the maximum corridors that should be used for various smoothing periods. The GFOA Best Practice specifies that a market corridor should be used if the asset smoothing period is longer than five years. The BRP/SOA report does not discuss market value corridors at all, and recommends that

asset smoothing — if used — should be limited to five years.

"Areas where the documents differ are in the structure and length of amortization periods by source of unfunded liability, and the application of 'market value corridors.'"

As to amortization of the unfunded actuarial accrued liability (UAAL), all three reports agree that 15 to 20 years is the preferred range for UAAL amortization periods. Both the GFOA Best Practice and the CCA PPC White Paper prefer fixed period "layered" amortization (*i.e.*, amortize each portion of the UAAL over a separate fixed period as it emerges), while the BRP/SOA report provides limited guidance on the structure of the UAAL amortization payments.

"All three reports agree that 15 to 20 years is the preferred range for UAAL amortization periods."

As discussed in the next section, the BRP/SOA Report also recommends a "Standardized Contribution Benchmark" that employs a rolling 15-year UAAL amortization period.

Tables 2–4 highlight the specific actuarial funding policy elements recommended in the reports (except for the AAA Issue Brief, which does not include detailed policy recommendations). Table 2 on the next

page compares recommendations for the actuarial cost method. Table summarizes the recommendations for asset smoothing. Table 4 on page 5 focuses on recommendations for UAAL amortization.

NOTABLE DIFFERENCES

Some differences among the recommendations can be attributed to differences in intended scope. As noted earlier, the AAA Issue Brief is more general and does not address specific policy details but is consistent in principle with the other documents. The CCA White Paper has by far the most comprehensive and detailed discussion of specific policy alternatives, with recommendations that are generally consistent with the GFOA Best Practice.

One notable difference is that the BRP/SOA Report recommends that public pension plans disclose to outside entities a variety of standardized 30-year projections under alternative actuarial assumptions, investment returns and even contribution amounts relative to the actuarially determined contribution. Perhaps the most controversial recommendation would be to disclose current and projected results using a "standardized contribution benchmark" based on a

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⁶ The AAA Issue Brief, in contrast, discusses only policy objectives, and not specific policy elements. Also note that, rather than recommending only certain policy practices, the CCA PPC White Paper uses categories including Model, Acceptable, Acceptable with Conditions, Non-recommended and Unacceptable. This discussion focuses primarily on its Model practices.

Table 2: Specific Actuarial Funding Policy Recommendations for Actuarial Cost Method: How Two of the Actuarial Organizations Compare to Each Other and to the GFOA Best Practice

Actuarial Cost Method Entry Age cost method with level percentage of pay Normal Cost.* For multiple tiers, Normal Cost is based on each participant's benefit (not "Ultimate Entry Age"). **CCA PPC** For benefit formula changes within a tier (generally after a fixed date), Normal Cost is based on White Paper current benefit structure ("Replacement Life" Entry Age). Entry Age Normal Cost averaged over career is also "acceptable." Aggregate, Frozen Initial Liability and Projected Unit Credit are "acceptable with conditions." **BRP/SOA** Individual Entry Age method used for "Standardized Contribution Benchmark." Report Entry Age cost method with level percentage of pay Normal Cost is "especially well suited" **GFOA Best Practice** to achieving the policy objectives.

Table 3: Specific Actuarial Funding Policy Recommendations for Asset Smoothing: How Two of the Actuarial Organizations Compare to Each Other and to the GFOA Best Practice

	Asset Smoothing
	Deferrals based on total return gain/loss relative to assumed earnings rate and recognized over fixed smoothing periods not less than three years.
CCA PPC White Paper	Maximum market value corridors for various smoothing periods: 5 years: 50%/150% corridor 7 years: 60%/140% corridor
	10 years with 70%/130% corridor is "acceptable."
	Combine smoothing amounts only to manage "tail volatility."*
BRP/SOA Report	Asset smoothing periods should be limited to five years or less. No discussion of market value corridors.
	Five-year smoothing with no corridor used for "Standardized Contribution Benchmark."
	Encourages the consideration of "direct rate smoothing" and other asset and liability cash flow modeling techniques.
GFOA Best Practice	Fixed period asset smoothing with periods of ideally 5 years or less but never longer than 10 years.
	Smoothing periods longer than 5 years should include a market value corridor.

^{*} Appropriate when the net deferral amount is relatively small (i.e., the smoothed and market values are very close together). The net deferral amount and the period over which the net deferral amount is fully recognized are unchanged as of the date of the adjustment. Avoid using frequent restart of smoothing to achieve de facto rolling smoothing. Avoid restarting smoothing only to accelerate recognition of deferred gains (i.e., only when the market value is greater than the smoothed value).

^{*} Normal Costs are level even if benefit accrual or eligibility changes with age or service. All types and incidences of benefits are funded over a single measure of expected future service. The Normal Cost for a tier of benefits is the sum of the individually determined Normal Costs for all participants in that tier. For plans with benefits unrelated to compensation, the Entry Age method with level dollar Normal Cost may be more appropriate.

Table 4: Specific Actuarial Funding Policy Recommendations for UAAL Amortization:
How Two of the Actuarial Organizations Compare to Each Other and to the GFOA Best Practice

UAAL Amortization

Layered fixed period amortization by source of UAAL; level percent of pay.

Model amortization periods:

CCA PPC White Paper 15 to 20 years for gains and losses

15 to 25 for assumption or method changes

Demographic* for plan changes; or 15 for actives, 10 for retirees

Combine gain/loss (and other) layers** or restart amortization only to avoid "tail volatility."

BRP/SOA Report Amortization of gains/losses should be completed over a period of no more than

15 to 20 years.

15-year rolling, level percent of pay amortization used for "Standardized

Contribution Benchmark."

GFOA Best Practice Layered fixed period amortization by source of UAAL; level percent of pay or level dollar. Ideally use a 15 to 20 year range, but never exceed 25 years.

Special considerations (e.g., longer periods) for amortizing a surplus.

discount rate specified in the BRP/SOA Report. The specified rate would be substantially lower than even the more conservative public pension plan investment return assumptions currently in use.⁷

While some additional sensitivity and risk related disclosures may

be appropriate, Segal does not support the disclosure by all public pension plans of the uniformly standardized contribution benchmark proposed by the BRP/SOA Report. Standardized financial reporting is already required by the GASB, based on a discount rate that is adjusted to reflect the projected funding of future benefits.

CONCLUSION

Actuarial funding policy is a crucial part of pension fund governance, and policymakers and administrators of public pension systems should be prepared to respond to inquiries regarding this recent funding policy guidance.

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Many plans will find that many of the recommendations are already in place. Sponsors of plans that are not following all of the recommendations may benefit from considering the guidance summarized in this *Public Sector Letter*, including consideration of any justifiable policy differences. Knowing how their plans compare

^{*} Use average future service for actives or average life expectancy for retirees. The amortization period should also be short enough to avoid negative cash flow, where the additional amortization payments are less than the additional benefit payments.

^{**} Combining layers should result in substantially the same current amortization payment. Avoid using restart of amortization to achieve de facto rolling amortization. Restart amortization layers when moving from surplus to UAAL condition.

⁷ The BRP/SOA Report states incorrectly that "the primary difference between [the BRP/SOA's] long-term rate of return and the rate used by many plans is that many plans use a historical average return for their discount rate. Other plans assume forward-looking rates, but based on historical average nominal returns, which factor in many different interest rate and inflation environments." In fact, it would be unusual for a public pension plan to set a long-term assumed rate of return in either of these ways. The main reason that the BRP/SOA discount rate is comparatively low is that it uses a particular model for estimating long-term investment returns, one based heavily on current U.S. Treasury security market prices and yield curves.

with the recommendations will help sponsors respond to any questions that may arise, as well as to identify possible policy changes.

Segal Consulting can help plan sponsors that have not recently reviewed their funding policy to analyze their policies to ensure that they meet the risk profiles and policy objectives of the plan stakeholders. For more information about

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funding policy reviews, contact your Segal consultant or one of the following experts:

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