



BEST PRACTICE

Core Elements of a Pension Funding Policy (CORBA) (2013)

Background. The Government Finance Officers Association (GFOA) has recommended that every state and local government that offers defined benefit pensions formally adopt a funding policy that provides reasonable assurance that the cost of those benefits will be funded in an equitable and sustainable manner.¹ To provide the desired degree of assurance, a pension funding policy would need to incorporate the following principles and objectives:

1. Every government employer that offers defined benefit pensions should obtain no less than biennially an actuarially determined contribution (ADC) to serve as the basis for its contributions;
2. The ADC should be calculated in a manner that fully funds the long-term costs of promised benefits, while balancing the goals of 1) keeping contributions relatively stable and 2) equitably allocating the costs over the employees' period of active service;
3. Every government employer that offers defined benefit pensions should make a commitment to fund the full amount of the ADC each period. (For some government employers, a reasonable transition period will be necessary before this objective can be accomplished);
4. Every government employer that offers defined benefit pensions should demonstrate accountability and transparency by communicating all of the information necessary for assessing the government's progress toward meeting its pension funding objectives.

These principles and objectives necessarily will affect decisions related to the treatment of three core elements of a comprehensive pension funding policy:

- *Actuarial cost method* - the technique used to allocate the total present value of future benefits over an employee's working career (*normal cost/service cost*).
- *Asset smoothing method* - the technique used to recognize gains or losses in pension assets over some period of time so as to reduce the effects of market volatility and stabilize contributions.
- *Amortization policy* - The length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded actuarial accrued liability or surplus.

Recommendations. To ensure consistency with the principles and objectives described above, the GFOA recommends that a pension funding policy treat each of its core elements as follows:

¹ "Guidelines for Funding Defined Benefit Pensions" (2013) (CORBA).

Actuarial cost method. The actuarial cost method selected for funding purposes should conform to actuarial standards of practice and allocate normal costs over a period beginning no earlier than the date of employment and should not exceed the last assumed retirement age. Moreover, the selected actuarial cost method should be designed to fully fund the long-term costs of promised benefits, consistent with the objective of keeping contributions relatively stable and equitably allocating the costs over the employees' period of active service.² While not the only method that would satisfy this criterion, the entry age method—level percentage of pay normal cost—is especially well suited to achieving this purpose.

Asset smoothing. The method used for asset smoothing should:

- Be unbiased relative to market. Thus, for example:
 - The same smoothing period should be used for both gains and losses, and
 - Market corridors (a range beyond which deviations are *not* smoothed), if used, should be symmetrical³, and
- Provide for smoothing to occur over fixed periods (the use of rolling periods normally should be avoided), ideally of five years or less, but never longer than ten years.
 - Provide for a market corridor if smoothing is to occur over a period longer than five years.

Amortization. Amortization of the unfunded actuarial accrued liability⁴ should:

- Use fixed (closed) periods that
 - Are selected so as to balance the twin goals of demographic matching (equitable allocation of cost among generations) and volatility management (funding at a level percentage of payroll) and
 - Never exceed 25 years, but ideally fall in the 15-20 year range;
- Use a layered approach for the various components to be amortized (that is, an approach that separately tracks the different components to be amortized); and emerge as a level percentage of member compensation or as a level dollar amount.

Additional considerations for plans closed to new entrants. When a plan is closed to new participants, the aggregate actuarial cost method – level percentage of pay normal cost – is especially well suited for funding.

For closed plans with no remaining active members:

- Special attention needs to be given to the mix of investments (given the shorter time horizon); and
- In comparison to open plans:

² Employers using some other actuarial cost method should carefully monitor demographic changes and trends in the covered workforce inasmuch as such changes could result in increased employer contributions as a percentage of payroll.

³ Generally, the appropriate corridor will depend upon the length of the smoothing period, with longer smoothing periods requiring narrower corridors.

⁴ Special considerations may apply to the amortization of a surplus (e.g., use of a longer amortization period).

- Asset smoothing periods should be shorter (typically no longer than three years);
 - Corridors, if used, should be narrower; and
- Amortization periods should be shorter (typically no longer than 10 years for gains and losses).

For closed plans that still have active members:

- The continued use of level percent of member compensation amortization remains appropriate, but *not* for a long period (i.e., as the number of active members decreases); and
- In comparison to open plans:
 - Asset smoothing periods should be shorter;
 - For asset smoothing periods that exceed five years, a corridor (not to exceed 20 percent) should be used; and
 - Amortization periods should be shorter.

References.

- California Actuarial Advisory Panel, *Actuarial Funding Policies and Practices for Public Pension and OPEB Plans*, February 2013 at:
http://www.sco.ca.gov/Files-ARD/BudLeg/CAAP_Funding_Policies_w_letter.pdf