Establishing a Funding Policy

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What is a Funding Policy?

- **Written Document that Sets the Policies for Determining How Much the Plan Sponsor(s) Should Contribute and When.**
- Should Be Collaborative Effort (Ideally):
  - Between Pension Board & Plan Sponsor, by Forming a Committee
  - Should Recognize Interests of Both Plan Members and Plan Sponsor

What is a Funding Policy?

- Funding Policies Should State & Describe:
  A. Actuarial Cost Method
  B. Asset Smoothing Method
  C. Amortization Procedures
  D. Procedures for Evaluating / Selecting Actuarial Assumptions

Why is a Funding Policy Needed?

1. Florida Statutes Help, but They. . .
   - Only Give Broad General Parameters (Maxes/Mins)
   - Are Incomplete for Boards to Strike a Balance Among Competing Objectives (**Volatility Control, Benefit Security, and Inter-Generational Equity**).
2. Principal Elements of a Funding Policy May Not Have Ever Been Well-Documented or Fully Considered / Deliberated by Boards

Why is a Funding Policy Needed?

3. To Help a Pension Plan Thrive By:
   - Giving Structure/Guidelines to Current/Future Board
   - Applying Best Practices
4. Helps Fulfill Promises to Plan Members
5. Gives Plan Members Confidence in Having Secure Lifetime Retirement Income

Why is a Funding Policy Needed?

6. Helps Defend DB Plans Against Accusations
7. Helps Keep State from Stepping in and Requesting Changes
8. Demonstrates Compliance With:
   - State Statutes and Rules
   - GASB Standards
   - Actuarial Standards of Practice

What is a Funding Policy?

- Four Primary Elements of a Funding Policy:

A. Actuarial Cost Method

B. Asset Smoothing Method

C. Amortization Procedures

D. Actuarial Assumption Procedures

Funding Policy Elements

A. Actuarial Cost Method

- The Method for Allocating the liabilities for all Future Benefits over all Years of Service to Distinguish Between Past and Future Liabilities and Set the Annual Cost Rate, which Impacts the Level and Timing of Contributions.

Funding Policy Elements (Cont.)

A. Actuarial Cost Method

- Examples of Actuarial Cost Methods:
  1. Entry Age Normal (EAN)
  2. Aggregate
  3. Projected Unit Credit (PUC)
  4. Frozen Initial Liability (FIL)

Funding Policy Elements (Cont.)

A. Actuarial Cost Method: Entry Age Normal

- For Each Individual, Present Value of Future Benefits Allocated Over All Years (Entry Age to Decrement Age) as a Level % of Pay
- Each Year's Allocation = That Year's "Normal Cost" (Expected to Remain a Level Percent of Pay)
- EAN is the Preferred Method of the Conference of Consulting Actuaries' White Paper
- GASB Requires use of EAN for Accounting
- Most Florida Pension Plans use EAN

Funding Policy Elements (Cont.)

A. Actuarial Cost Method: Aggregate

- Total Present Value of Future Benefits (PVFB) in Excess of Assets is Allocated over Present Value of Future Salaries (PVFS) as a Level Percent of Pay
- Popular for Closed Plans → Finances All Liabilities by the Time there are no more Active Employees
- No Explicit Unfunded Actuarial Liability (UAL) or Specified Number of Years for Amortization
- Normal Costs are More Volatile than with EAN

Funding Policy Elements (Cont.)

A. Actuarial Cost Method: Projected Unit Credit (PUC)

- Normal Cost is more “Back-Loaded”, meaning it is likely to increase over time as a Percentage of Pay
- PUC Actuarial Accrued Liability usually lower than EAN Actuarial Liability

Funding Policy Elements (Cont.)

B. Asset Smoothing Method

- To Determine the Actuarial Value of Assets (AVA) used in the Valuation
- Can Use Market Value of Assets (MVA)
  - But it will be more volatile
- Most Plans Use Asset Smoothing to smooth out year-to-year fluctuations in the Market Value of Assets

Funding Policy Elements (Cont.)

B. Asset Smoothing Method

- Asset Smoothing Allowed under Florida Statutes, but over a max of 5 years; must remain within 20% of MVA
- Common Smoothing Methods in FL:
  1. LY's AVA increased by Compound Average of MVA % Returns Over the Last X Years
  2. Weighted Average of MVA and Expected AVA
  3. Direct X-Year MVA Gain/Loss Write-Down

Funding Policy Elements (Cont.)

B. Asset Smoothing Method

- AVA Should be Projected to Converge to MVA Within 5 Years if Actual Investment Returns on the MVA Equal Assumed Returns
- Each Method has Pros and Cons
- Not a Significant Difference in Results

Funding Policy Elements (Cont.)

C. Amortization Procedures

- Periods for Paying Off Unfunded Liabilities
- Periods may Differ Depending on Type of Base (Cause of the Unfunded Liability)
- Florida Statutes (per Ch. 112.64(4), F.S): 30-year max
  - However, 30 years considered too long by many experts

Funding Policy Elements (Cont.)

C. Amortization Procedures

- When Setting Amortization Periods, Should Balance Competing Objectives
  - Balance Volatility Control with Benefit Security and Inter-Generational Equity
- Shorter Periods Provide more Benefit Security and Inter-Gen. Equity; Longer Periods → Less Volatility

Funding Policy Elements (Cont.)

C. Amortization Procedures

- **GFOA says**: "*Never exceed 25 years, but ideally fall in the 15-20 year range*"
- **Conference of Consulting Actuaries White Paper says**: "*an ideal amortization period range is 15 to 20 years*" to favor Inter-Generational Equity and Benefit Security but still provide some Volatility Control

Funding Policy Elements (Cont.)

C. Amortization Procedures

- Types of Amortization Bases
  1. Changes in Liability Due to Plan Amendments (Benefit Changes)
  2. Changes in Assumptions / Methods
  3. Experience Gains / Losses
- May Set Different Amortization Periods for Each Type of Base

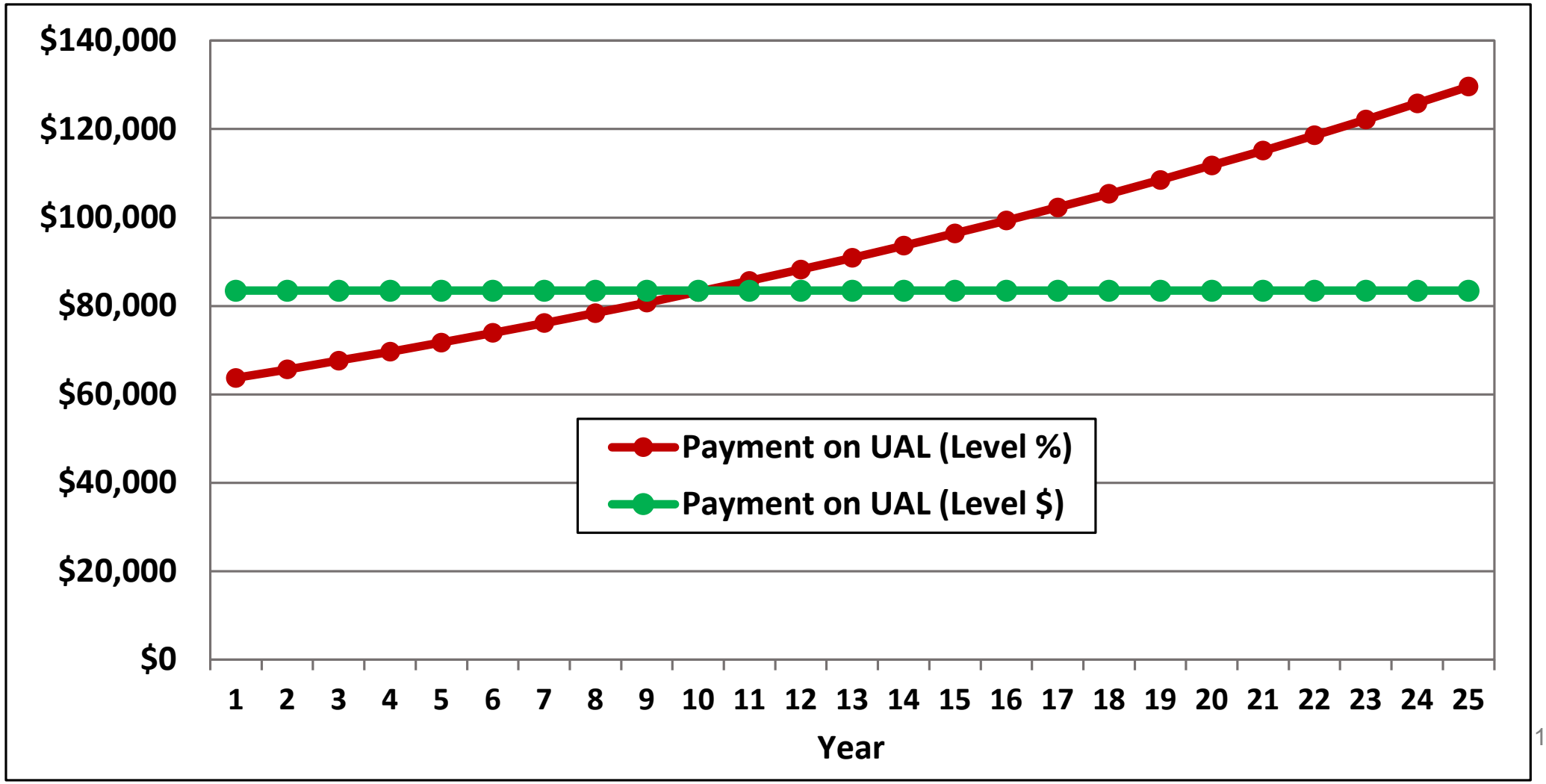
Funding Policy Elements (Cont.)

C. Amortization Procedures

- Two Types of Amortization
  1. Level Dollar (Same Payment Amount Every Year)
  2. Level Percent of Pay
     - Payments Increase Over Time by an Assumed Payroll Growth Rate
     - The Higher the Assumed Payroll Growth Rate, the Lower the Initial Payment and the Higher the Ultimate Payment

Funding Policy Elements (Cont.)

- Level Dollar vs. Level Percent of Pay:

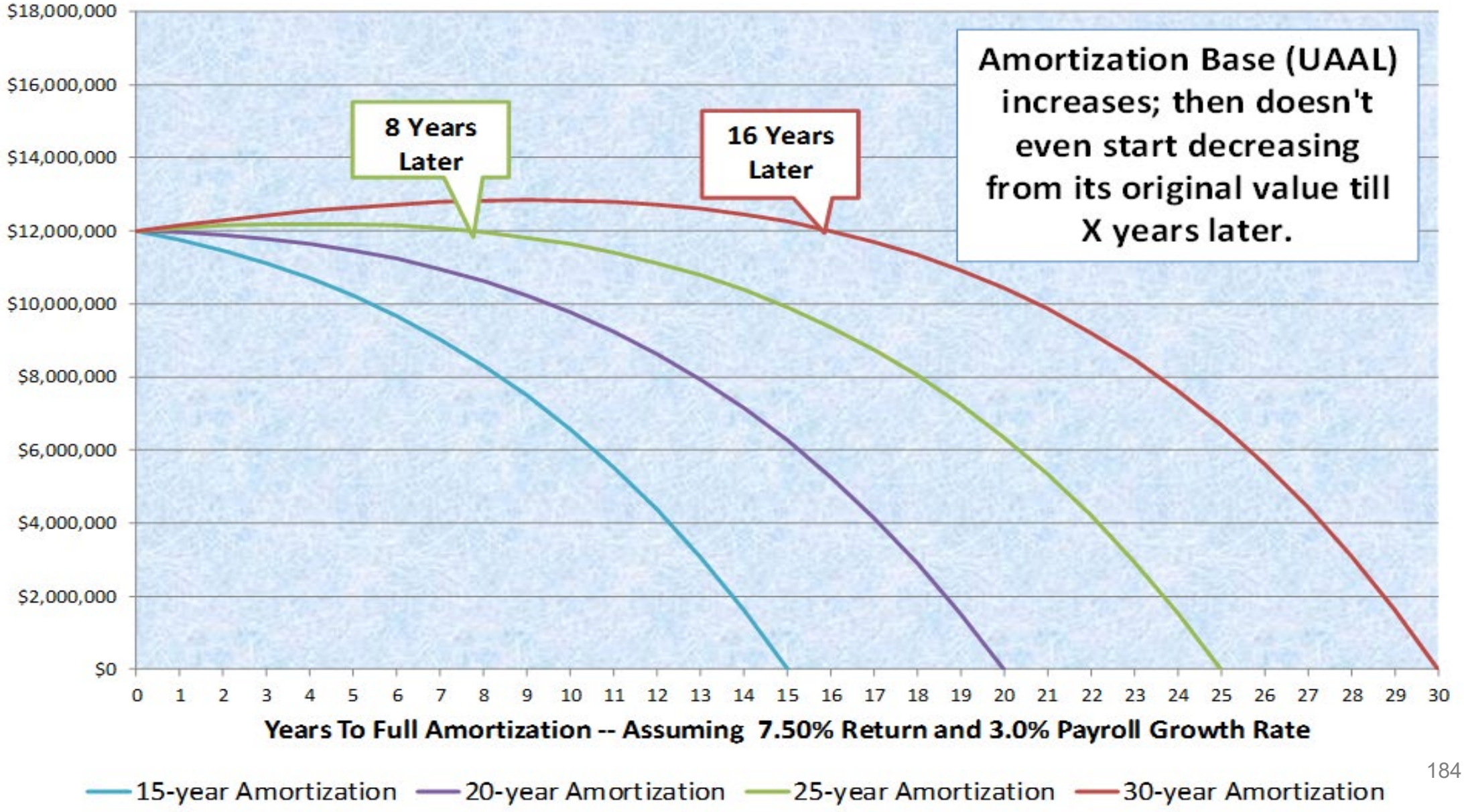


Funding Policy Elements (Cont.)

C. Amortization Procedures

- Level Percent of Pay Amortization
  - Ch. 112.64(5), F.S., Limits Payroll Growth Rate to Max of Actual 10-Year Historical Average Payroll Growth Rate (with some exceptions)
  - If Amortization Period > 20 Years and Payroll Growth Rate ≥ 3%, Could Have Negative Amortization (Payment Less Than Interest; UAL Increases)

Pay-down of an Amortization Base Illustrating Negative Amortization



Funding Policy Elements (Cont.)

C. Amortization Procedures

- Level Dollar is More Conservative Than Level Percent of Pay
- Closed / Frozen Plans Should Always Amortize as a Level Dollar Amount (Payroll is Declining)

Funding Policy Elements (Cont.)

D. Actuarial Assumption Procedures

- Funding Policy does not Set Actuarial Assumptions Themselves, but Describes Procedures to Follow When Evaluating / Adopting Actuarial Assumptions
  - Frequency of Experience Studies
  - Process for Setting Inflation and Investment Return Assumptions

Funding Policy Elements (Cont.)

D. Actuarial Assumption Procedures

- GFOA / CCA Best Practice: Conduct an Experience Study to Evaluate Actuarial Assumptions Once Every 5 Years
- Results of Experience Studies are Used to Set Assumed Rates of Retirement, Turnover, Disability, and Salary Increases
  - Mortality Rates Set by Law

Funding Policy Elements (Cont.)

D. Actuarial Assumption Procedures

- Establish Disciplined Process for Setting the Inflation and Investment Return Assumptions
  - Should Be Based on Professional Input
  - Should Be Based on Forward-Looking Market Forecasts
  - Should Consider Multiple Sources
  - Should Re-evaluate Every 3-5 Years

Creating a Funding Policy

1. Form a Committee Comprised of Board Members, Plan Sponsor Representatives, Plan Actuary, and Attorney
2. Conduct Workshop / Education Session on Funding Policy Elements
3. Review and Understand Current Funding Policy, Even if a Written One Does Not Exist (Relevant Statutes / Ordinances, Methods Previously Adopted By Board, Current Practices in Actuarial Valuation)

Creating a Funding Policy

4. Review / Discuss Funding Policy Goals and Make Decisions on the Four Funding Policy Elements
5. Prepare a Draft Written Funding Policy and Have Legal Counsel Review it
6. Finalize and Communicate it to all Stakeholders
7. Monitor Compliance with the Funding Policy
8. Review/Amend Over Time as Needed

Appendix

- ***Government Finance Officers Association (GFOA)***

  http://www.gfoa.org/sustainable-funding-practices-defined-benefit-pension-plans

  http://www.gfoa.org/core-elements-funding-policy

  http://www.gfoa.org/funding-defined-benefit-pensions

  http://www.gfoa.org/best-practices?field_committee_value=All&term_node_tid_depth%5B%5D=105&term_node_tid_depth%5B%5D=106&term_node_tid_depth%5B%5D=107&term_node_tid_depth%5B%5D=136&term_node_tid_depth%5B%5D=104

- ***Conference of Consulting Actuaries (CCA)***

  This is the definitive work to date on funding policy matters for public sector pension plans. Here is an excerpt from the White Paper's cover letter: "The CCA PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems in the US. All of the major actuarial firms serving the public sector are represented in the CCA PPC as well as in-house actuaries from several state plans. As a result, the CCA PPC represents a broad cross section of public-sector actuaries with extensive experience providing valuation and consulting services to public plans, and it is that experience that provides the knowledge base for this paper."
  http://ccactuaries.org/publications/news/CCA-PPC-White-Paper-on-Public-Pension-Funding-Policy.pdf

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