Recommended Practice

Funding of Public Employee Retirement Systems (1994, 2005, and 2008) (CORBA)

Background. The fundamental financial objective of a state or local government employee retirement system is to fund the long-term cost of promised benefits to the plan participants. This is accomplished through contributions by the employer and employee, and the investment program. Contributions are often expressed as a percentage of active member payroll, which should remain approximately level from generation to generation. Embodied in this objective are the principles of accrual accounting, which require that the total cost of employee services be recognized in the period in which those services are rendered. Creation of a funding policy that embodies this funding objective is a prudent governance practice and would achieve intergenerational equity among those who are called on to financially support the plan, thereby avoiding transfer of costs to future generations.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government officials ensure that the costs of the benefits promised are properly measured and reported, in accordance with standards established by the Governmental Accounting Standards Board (GASB). In pursuing these standards, public officials and retirement system trustees should, at a minimum, adhere to the following recommended practices:

1. Adopt a funding policy targeting a 100 percent or more funded ratio (full funding) over a reasonable period of time (full funding is necessarily tied into the amortization period). The policy should stipulate that contributions are to be made on a periodic basis, with the contribution amount determined by the results of a recent actuarial valuation of the system. To ensure that the objectives of the funding policy can be achieved, it should be integrated with investment and asset allocation policies.

2. Have an actuarial valuation prepared at least biennially by a qualified actuary in accordance with generally accepted actuarial principles and practices and conforming to GASB requirements. With each valuation, have a gain/loss analysis prepared that identifies the magnitude of actuarial gains and losses, based on variations between actual and assumed experience for each major assumption.

3. Actuarial assumptions should be carefully reviewed by retirement system staff, discussed with professional experts (including investment advisors), and explicitly approved by trustees. Assumptions that should be carefully reviewed include the long-term return on assets, salary growth, inflation, and any anticipated changes in the covered population of plan participants.

4. Have an actuarial experience study performed at least once every five years, and update actuarial assumptions as needed.

5. Establish a period for amortization of unfunded actuarial accrued liabilities that does not exceed the parameters established by GASB[1] and that is consistent with the funding policy of the plan. The funding policy should provide for a stable amortization period over time, with parameters provided for making changes that are based on specific circumstances.

6. Ensure that annually required contributions (ARC) are collected by the retirement system on a timely basis to achieve the plan’s stated funding policy. Reductions or postponements in collecting the ARC would

[1] GASB standards require a maximum amortization period of no longer than 30 years.

typically be inconsistent with the assumptions made in computing the ARC. When the employee or employer contributions fall below the ARC, the board of trustees should consider preparing a report that analyzes what effect the underfunding has on the system. The report should be distributed to all stakeholders.

7. Have an audit of the plan's actuarial valuations performed by an independent actuary at least once every five to eight years. The purpose of such a review is to provide an independent critique of the reasonableness of the actuarial methods and assumptions in use and the validity of the resulting actuarially computed contributions and liabilities.

8. Prepare and widely distribute a comprehensive annual financial report (CAFR) covering retirement system activity, and distribute summary information to all plan participants. The CAFR should be prepared following the guidance provided by the GFOA for the preparation of a public employee retirement system CAFR.

9. Discuss the funding and amortization methods with your actuary, and select the one that most closely aligns with the funding policy. The actuarial funding method selected is a key component of the funding policy of the plan. Some funding methods may result in more variations in the ARC than others. Governments should take measures to reduce the volatility in the ARC in order to create a more predictable operating budget and enhance their ability to meet funding obligations.

GFOA recommends the following options to reduce ARC volatility:

1. *Smoothing returns on assets.* Smoothing investment returns over several years recognizes that the system's investment portfolio performance does fluctuate, and only by coincidence will it exactly equal the assumed actuarial rate of return for any given year. This approach reduces the volatility within the calculation of the ARC. A smoothing period is used to balance the need for a longer term investment horizon with the short term market fluctuations in the value of plan assets. While the smoothing period is typically about five years, there is no reason it cannot be longer, if controls are in place to assure that any variation between the market value and actuarial value of assets does not become too large. A common approach is to establish corridors around market value of assets[2] to stipulate the maximum percentage by which the actuarially smoothed value will be allowed to deviate from the actual market value. Once a smoothing method is established, the retirement board should adhere to it and avoid making arbitrary changes to the methodology.

2. *Diversifying the investment portfolio to reduce volatility in investment returns.* Diversifying assets across and within asset classes is a fundamental risk management tool that also has the effect of reducing the fluctuations in ARC volatility. Although annual changes in the ARC are affected by numerous factors, the most significant is usually investment return. It is recommended that retirement systems periodically conduct asset-liability studies for use in reviewing their asset allocation policies.

3. *Managing investment returns long term*. Because the investment return assumption is an average long-term expected rate of return, excess earnings in any one year will likely be offset by lower-than-expected rates of return in a future year. Thus, any program that is derived from an excess-earnings concept is detrimental to the funded status of the plan.

4. *Managing growth in liabilities.* Managing growth in liabilities should also be done long term. All benefit increases for members and beneficiaries should be carefully considered and appropriately approved, and be consistent with all Internal Revenue Service requirements. Whether cost of living adjustments (COLAs), benefit formula enhancements, or post-retirement benefit increases, a clear strategy should be developed that integrates benefit enhancements with the funding policy of the plan. Further, all benefit enhancements and COLAs should be actuarially valued before they are adopted so the effect of the benefit enhancements

[2] A corridor of 80 percent to 120 percent is common, depending on the smoothing period.

on the fund's actuarial accrued liability, funded ratio, and contribution rates is fully understood. This step will help ensure that the goal of fully funding member benefits is achieved, and the financial condition of the retirement system remains sustainable.

5. *Maintaining vigilance against ethical violations and benefit calculation abuse.* While affecting only a small percentage of retirement systems, and often only in select instances in these systems, headline-grabbing abuses of retirement benefit enhancements such as salary spiking can create negative public perceptions that are harmful to all retirement systems. Policies to safeguard against these abuses or undesired outcomes should be considered.

Resources.

- GFOA Recommended Practice: *Evaluating the Use of Pension Obligation Bonds*, 2005.
- *Public Pension Systems – Operational Risks of Defined Benefit and Related Plans and Controls Investment Policy Checklist for Pension Fund Assets*, GFOA, May 2003.
- *A Guide for Selecting Pension Actuarial Consultants: Writing RFPs and Evaluating Proposals*, Robert Pam, GFOA, 1999.
- *An Elected Officials Guide to Public Retirement Plans*, Cathie G. Eitelberg, GFOA, 1997.
- *Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report*, Stephen Gauthier, GFOA, 1996.
- *Pension Accounting and Reporting, Second Edition*, William R. Schwartz, GFOA, 1995.
- *Financing Retirement System Benefits*, Richard G. Roeder, GFOA, 1987.
- Governmental Accounting Standards Board, www.gasb.org.

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