Government Finance Officers Association

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

Background. The fundamental financial objective of a state or local government employee retirement system is to establish a funding policy, and receive contributions which, expressed as a percentage of active member payroll, will remain approximately level from generation-to-generation based on the plan's existing benefit package while fulfilling the long-term goal of fully funding member benefits. 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. The level contribution design of pension plan funding is intended to assign pension costs for the employee population to the appropriate fiscal periods.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government officials carry out their assigned duties of assuring that benefits promised are properly measured and then reported in accordance with standards established by the Actuarial Standards Board (ASB) and the Governmental Accounting Standards Board (GASB), and that actuarially required contributions (ARC) are collected by the pension plan. In pursuing these objectives, public officials and pension plans should, at a minimum, adhere to the following recommended practices:

1. Have an actuarial valuation prepared at least biennially by a qualified actuary in accordance with the principles and procedures established by the ASB. The valuation should be prepared using funding methods and assumptions that are adopted following discussion with the actuary and should conform with the requirements of ASB and GASB.

2. Establish a period for amortization of unfunded actuarial accrued liabilities that conforms with the parameters established by GASB.

3. Assure that actuarially required contributions are collected by the pension plan on a timely basis, so as to achieve the plan's stated funding policy. Reductions in or postponement of the ARC violates one of the basic principles of level percent-of-payroll financing and constitutes a real threat to responsible funding.

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

5. Have a review of the plan's actuarial valuations performed by an independent actuary at least once every 10 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 resulting actuarially computed contributions and liabilities.

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

Additionally, GFOA recommends that governments take measures to reduce the volatility in the ARC in order to create a more predictable operating budget and enhance the governments' ability to meet their funding obligations. Recommended options to reduce ARC volatility include the following:

- Smoothing returns on assets – Averaging the investment returns over several years will smooth the return on the actuarial value of assets. In determining the number of years to smooth assets, governments must balance the need for responsiveness in the actuarial value of assets (a shorter period) and the need to mitigate market fluctuations (a longer period). Regardless of the smoothing period selected, governments should establish "corridors" around market value to ensure that the gap between the actuarially smoothed value and market values is not excessive. Once a smoothing method is determined, a pension system should adhere to it and avoid making arbitrary changes to the methodology.

- 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 ARC are affected by numerous factors, the most significant is investment return. In addition to diversification, it is recommended that pension systems periodically conduct an asset-liability study to ensure that assets track liabilities. Through asset-liability modeling it is possible to construct an investment portfolio that effectively manages the gap between assets and liabilities.

- Managing growth in liabilities – Automatic benefit enhancements, gain sharing, allocation of surplus earnings to beneficiaries, and changes of the benefit formula to provide extraordinary pension increases to employees should be opposed. Rather, a clear benefit enhancement policy should be developed that integrates benefit enhancements itself with the funding policy of the plan. Because employers bear all of the investment risk in a defined benefit plan, investment earnings that exceed the actuarial assumed rate of return must be safeguarded for years when they do not exceed the target return. As part of collective bargaining, pension plan administrators may be able to advise plan sponsors of the impact of any benefit enhancements sought by employee groups.

- Establishing additional reserve funds – Pension systems may consider establishing an additional reserve fund to be used to accept funds when actuarial results are better than expected, and release monies in the fund when results are poorer than expected.

- Selecting a funding method – Pension systems operating a final pay plan as commonly used in the public sector may have the discretion to select the funding method that creates the least volatility in the contribution rate. For example, to set contribution rates as a percent of payroll, governments may consider using the "entry-age normal" method, with normal cost as a percent of pay, and amortize any unfunded actuarial liability using a level growth in payroll. For plans with flat dollar contributions and benefits, governments may consider entry-age normal with normal cost as a level dollar amount.

References

- *Financing Retirement System Benefits,* Richard G. Roeder*,* GFOA, 1987.
- *Pension Accounting and Reporting*, *Second Edition*, William R. Schwartz, GFOA, 1995.
- *Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report,* Stephen Gauthier, GFOA, 1996.
- *A Guide for Selecting Pension Actuarial Consultants: Writing RFPs and Evaluating Proposals,* Robert Pam, GFOA, 1999.
- GFOA Recommended Practice: *Evaluating the Use of Pension Obligation Bonds*, 2005.

Approved by the GFOA's Executive Board on October 11, 2005.