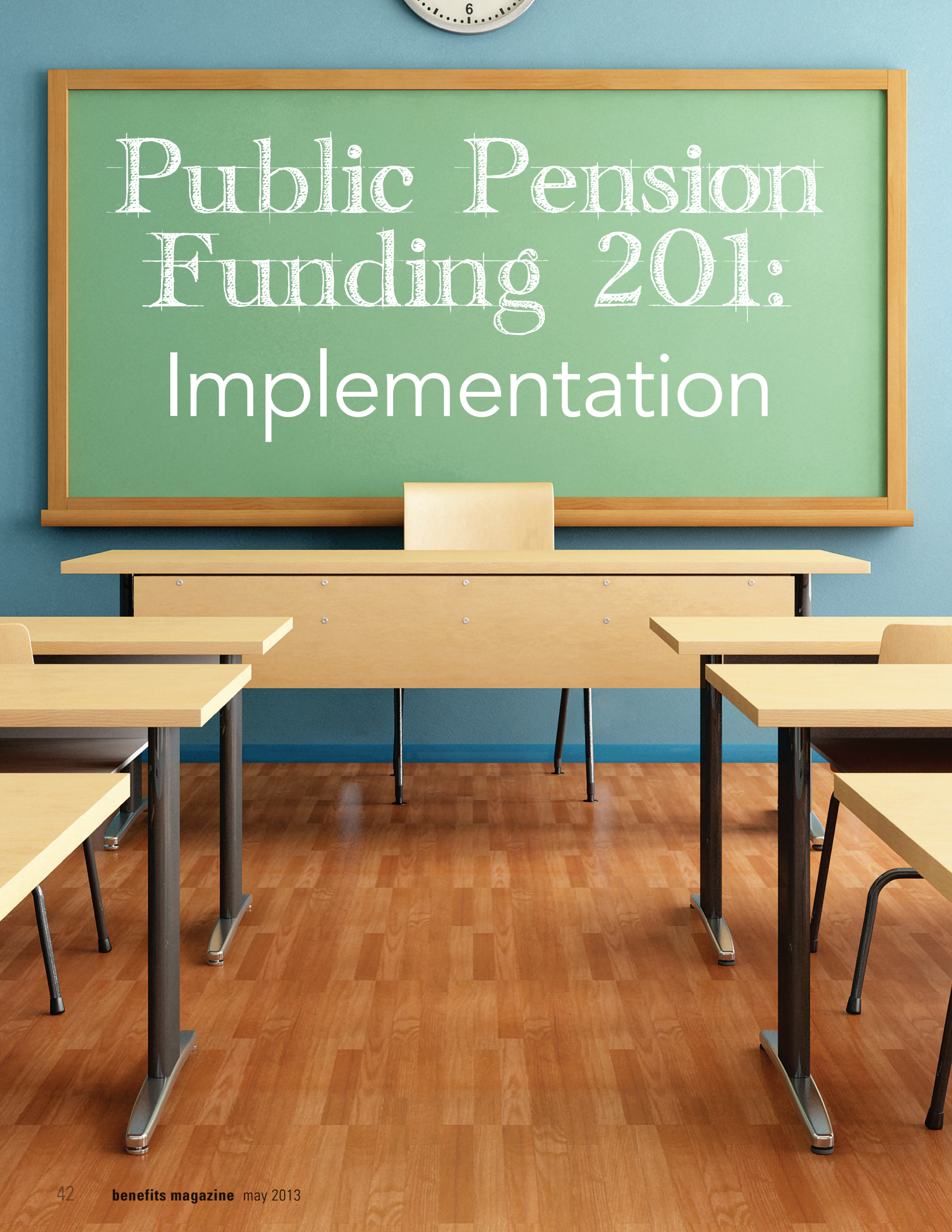

Public Pension Funding 201: Implementation

Past, current and future practices in public pension funding are described in this article, the second in a series that began in the April *Benefits Magazine* with definitions of terms and concepts necessary for an understanding of the topic.

by | **Keith Brainard**

Federal statistics report that more than 85% of employees of state and local government participate in a pension plan. Nearly all of these workers are in plans whose benefits are *prefunded*, meaning they are financed, entirely or partly, with assets accumulated during the employee's working years. Although this method for paying for pension benefits seems straightforward and logical, it has not always been standard practice.

A generation ago, there was no industrywide, systematic effort to measure the long-term liabilities and costs of public pensions. Nor was there an industrywide, systematic effort to fund the benefits. A 1979 study by the Government Accountability Office found that "many state and local government pension plans are not funded on a sound actuarial basis because they are not setting aside sufficient funds to provide for future benefits." This study discovered that some plans operated on a *pay-as-you-go basis*, meaning that current receipts of the employer were used to pay for current benefits. Several proposals to extend major provisions of the Employee Retirement Income Security Act (ERISA)—the body of federal laws that regulates corporate and multiemployer pensions—to state and local government pensions were introduced in Congress during the late 1970s.

While federal efforts to regulate state and local pension plans were not successful, the creation in 1984 of the Governmental Accounting Standards Board (GASB) began a process that would lead to establishment of a more systematic and orderly means for funding state and local government pension benefits.

In 1986, the new GASB issued Statement 5, which encouraged public pensions and their sponsoring governments to conduct regular actuarial valuations, including measurement of their liabilities. However, GASB does not have the authority to require compliance with its accounting standards, and Statement 5 lacked incentives for public employers to fund their pensions. Several years later, in 1994, GASB issued

Pension Funding Policies, Practices Vary

Although pension plans covering the vast majority of public employees conduct annual actuarial valuations, not all states and cities actually fund their pension plan on the basis of the valuation. Rather, pension plan sponsors have funding policies that prescribe how pension benefits should be paid for. Some of these policies fix employer contribution rates in statute; some don't follow their own funding policies, instead appropriating funds on the basis of decisions made in a political or legislative environment.

Pension funding policies and practices matter because studies consistently show, not surprisingly, a close relationship between a plan sponsor's contribution effort and the funding condition of the plan. Pension plans that regularly receive their annual required contribution (ARC) are in better funding condition than those that do not.

A Government Finance Officers Association best practice "recommends 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."

Similarly, in a 2011 resolution, the National Association of State Retirement Administrators expresses the organization's support for "disciplined funding of established benefits and efforts to ensure the financial integrity of public employee retirement systems."

Among states, pension funding policies and practices run a wide range, from complete obedience to the contribution rate recommended by the actuary, to approving whatever amount may be available at the end of an appropriations process, which could be zero. Reviewing a sample of state funding policies and practices may be instructive.

Delaware statutes require the legislature to appropriate the full annual cost required to fund the plan each year. Similarly, Utah state statutes require payment by employers of the ARC. The Delaware Public Employees' Retirement System and the Utah Retirement System consistently receive their full ARC and, not surprisingly, their pension plans are among the best-funded public pension plans in the United States.

By contrast, some states establish contribution rates in statute that are not linked to the ARC. For example, California maintains a fixed rate contribution for the state's school districts. At 10.27% of teacher pay, this rate, combined with the employee contribution rate, has been less than the ARC for more than ten years. Not coincidentally, the California State Teachers' Retirement System faces potential insolvency unless significant reforms are made.

There also are cases in which the amount contributed to public pension plans has been arbitrary. For example, New Jersey state statutes direct the legislature to "appropriate funds sufficient to provide for such [pension] obligations of the state." Yet the New Jersey legislature has repeatedly violated its own statutory requirement to fund its pension benefits, relying on court rulings that permit the legislature to disregard such a requirement.

Similarly, Illinois statutes require payment to some state plans, including the state employees' and state teachers' plans, of actuarially determined contributions necessary to reach a designated funding level by a future date. Yet the Illinois legislature, like that of New Jersey, has routinely failed in recent years to abide by these statutes, sometimes paying just a fraction of the statutorily required rate.

Predictably, pension plans in Illinois and New Jersey are among the most poorly funded statewide plans in the United States.

Statements 25 and 27. These statements created, for the first time, an incentive for governmental employers to make an earnest effort to fund their pension benefits.

Statements 25 and 27 accomplished this in part by establishing an actuarially determined contribution, known as the *annual required contribution (ARC)*: the sum of the *normal cost* (the cost of pension benefits accrued each year) and the cost to amortize the plan's unfunded liability. The new statements also required reporting of the ARC and the employer's effort toward funding its ARC. This allowed users of financial reports to see clearly whether the employer was making an effort to fund its pension obligations. Although GASB does not have the authority to require states and cities to comply with its statements, employer compliance with GASB assists governmental entities to secure a lower rate of borrowing in municipal bond markets.

In its 2008 paper, *The Miracle of Public Pension Funding*, the Center for Retirement Research (CRR) at Boston College credits GASB for the remarkable improvement in the funding condition of public pensions. CRR referred to this improvement as "miraculous," because it occurred so quickly and without federal legislation or regulation.

As the CRR report stated, multiple studies show that Statements 25 and 27 resulted in substantial improvement in pension funding. Before describing the details of what fostered what CRR called a "miracle," readers should know that GASB recently has replaced these statements with new ones, rendering Statements 25 and 27 obsolete beginning next year. The new statements are described briefly later in this article; since this article is about pension funding (and not GASB), it will focus on the GASB statements that provoked improvements in pension funding efforts.

In compliance with Statements 25 and 27, the first step in the process of funding a pension benefit is the *actuarial valuation*, the mathematical process of determining a pension plan's liabilities, funding condition and required

future costs. Calculating future costs requires the use of many assumptions about future events. These assumptions fall into one of two broad categories: economic and demographic. *Economic assumptions* are those pertaining to financial events, particularly rates of inflation, investment return and salary growth. *Demographic assumptions* refer to participant experiences, such as at what age workers will retire and how long they'll live after retiring.

An actuarial valuation also requires the use of a *funding period*, which is the time frame over which an unfunded pension liability is projected to be paid off. Funding a pension plan has been likened to paying off a home mortgage: The obligation is paid off through regular payments made over many years. An actuarial valuation can be thought of as a periodic assessment of progress toward paying off a long-term obligation. Others have likened a public pension actuarial valuation to a snapshot in a motion picture that unfolds over decades.

In addition to actuarial assumptions and a funding period, another element of the actuarial valuation is the *actuarial cost method*, which determines how pension costs are allocated over the course of a plan participant's working life. Some cost methods *front-load* costs, meaning costs are higher in earlier years. Other methods *back-load* costs, meaning higher costs occur in later years. The cost method used by most public pension plans is known as *entry age*; this method emphasizes the determination of a level, or stable, employer cost as a percentage of payroll.

Under Statements 25 and 27, the key outputs of a public pension actuarial valuation are the determination of the plan's actuarial liabilities, actuarial

How Investment Return Assumption Influences Funding

The investment return assumption used by public pension plans has received growing attention in recent years. No other single assumption has as much impact on the funding condition and cost of a pension plan as the assumed investment return.

Over time, investment earnings typically finance a majority of the cost of a pension benefit. An investment return assumption that is set too low will overstate liabilities and costs, overcharging current taxpayers and undercharging future taxpayers. A rate set too high will understate liabilities, undercharging current taxpayers at the expense of future taxpayers. An assumption that is significantly wrong in either direction will result in a misallocation of resources and an unfair distribution of costs among generations of taxpayers.

The process used by public pensions to establish and review their investment return assumption involves consideration of various financial, economic and market factors. This process also is based on a very long-term view, typically 30 to 50 years. A primary objective for using a long-term approach in setting the return assumption is to promote stability and predictability of cost.

By contrast, corporate plans are required by federal regulations to make contributions on the basis of current interest rates. This method results in plan costs that are volatile and uncertain, often changing dramatically from one year to the next. This volatility is due in part to fluctuating interest rates and has been identified as a leading cause of corporations' decisions to abandon their pension plans. By focusing on the long term and relying on a stable investment return assumption, public plans experience less cost volatility.

The investment return assumption actually contains two components: One is the assumption for inflation, and the other is the real rate of return. Among plans in the Public Fund Survey, the median inflation assumption is 3.5%, and the median real rate of return is 4.5%. The inflation assumption affects other facets of a plan's valuation, especially the assumed rate of salary growth. Reducing the salary growth assumption normally also results in a reduction in the plan's projected liabilities and cost.

According to the Public Fund Survey, more than one-third of public pension plans have reduced their investment return assumption within the last three years. These changes have reduced the average return assumption from 8.0% to around 7.8%. Despite strong market volatility since 2000, including two sharp equity market declines, median public pension fund investment returns for the ten- and 20-year periods that ended December 31, 2012 are equal to or greater than current average investment return assumptions.

takeaways >>

- Although prefunding public employee pensions makes sense, it hasn't always been standard practice, and efforts to extend ERISA protections to public pensions have failed.
- The creation of GASB led to a more systematic, orderly means for funding state and local government pension benefits. Compliance with GASB helps governmental entities secure a lower rate on the municipal bond market.
- A public pension actuarial valuation determines the plan's actuarial liabilities, actuarial value of assets, net unfunded liabilities, funding level and required cost, usually stated as a percentage of the plan's total payroll.
- GASB standards that take effect in 2014 and separate accounting from funding will mean a shift in how public pensions will be reported in public sector financial statements.
- The condition of plans that have not been funded consistently may be in for greater scrutiny because of the new standards.

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value of assets, net unfunded liabilities, funding level and required cost. The cost typically is expressed as a percentage of the plan's total payroll. Because employee contribution rates usually are fixed in statute, the valuation will determine the employer's cost net of the employee contribution.

In sum, GASB's ARC has served as the public pension community's de facto funding standard since the mid-1990s, and is credited with significantly improving the funding level of many public pension plans and of the public pension community as a whole. (See the sidebar, "Pension Funding Policies, Practices Vary.")

After several years of review, draft proposals, discussion and feedback, GASB in 2012 issued new standards for how public pension plans, and the states and cities that sponsor them, should calculate and report pension liabilities and costs. These new standards mark a fundamental shift in how public pensions are accounted for and reported in public sector financial statements.

Perhaps the most significant change in the new statements is their separation of accounting from funding. Where the old statements, via the ARC, served as a de facto funding standard, the sole focus of the new standards will be on accounting, not funding. As a result, no longer will actuarial valuations produce a single calculation that will be recognized as both a pension plan's accounting and funding position. Rather, public pensions are likely to produce two sets of actuarial calculations—one to satisfy GASB requirements, the other to inform policy makers of the amount needed to fund the plan. (See the sidebar, "How Investment Return Assumption Influences Funding.")

The incoming GASB standards, known as Statement 67 and Statement 68, will bring with them some new terms and concepts. Notably, basic financial statements prepared pursuant to the new standards will reflect solely the accounting condition of the pension plan, not its funding position. Thus, the new GASB standards will not require employers to change the way they fund their pension benefits. This is especially true for employers that have a history of funding their plan. For employers that have not consistently funded their plan, the new standards may result in greater scrutiny of the plan's condition, which may cause the employer to strengthen its effort to fund the benefits.

For plans covering most public employees, in cases where the employer contribution rate is contractually required or actuarially determined, the new standards will require employers to disclose this information along with the actual contribution made. GASB will require that ten years of this historical information be presented.

The new GASB standards take effect in fiscal years beginning after June 15, 2014. Meanwhile, a group of public pension actuaries and a group representing public sector organizations are working to establish new funding guidelines to take the place of the outgoing GASB funding standards.

<< bio

Keith Brainard is research director of the National Association of State Retirement Administrators (NASRA) in Georgetown, Texas. He collects, prepares and distributes to NASRA members news, studies and reports pertinent to public retirement system administration and policy. Brainard is co-author of *The Governmental Plans Answer Book, Second Edition.* He created and maintains the Public Fund Survey, an online compendium of public pension data sponsored jointly by NASRA and the National Council on Teacher Retirement. He previously served as manager of budget and planning for the Arizona State Retirement System and provided fiscal research and analysis for the Texas and Arizona legislatures. Brainard has a master's degree from the University of Texas–Austin, LBJ School of Public Affairs.