



# PERSPECTIVES

## A Comprehensive Funding Policy: The Recommended Instrument for Navigating Public Plan Funding

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### Introduction

Over a decade ago, the Governmental Accounting Standards Board (GASB) issued GASB Statements No. 67 and No. 68 that made significant changes to the accounting and financial reporting standards for state and local government pension plans and their sponsoring governments. Subsequently, GASB Statements No. 74 and No. 75 for other postemployment benefit (OPEB) plans were issued. None of these standards established any prescriptive disclosures regarding funding policy.

For the first few years after the standards were released in 2012, there was a great deal of activity at the pension board level focused on developing funding policies. Since then, the American Academy of Actuaries (AAA), the Actuarial Standards Board (ASB) and the Government Finance Officers Association (GFOA) have issued recommendations for plans to adopt comprehensive funding policies.

A revised Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*<sup>1</sup>, became effective February 15, 2023 for all actuarial reports with a measurement date on or after February 15, 2023. ASOP No. 4 Section 3.19 effectively requires the actuary to assess the implications of the funding policy when performing a funding valuation.

In the following month (on March 23, 2023), the GFOA Board approved a revised Best Practice on the *Core Elements of a Funding Policy for Governmental Pension and OPEB Plans*.<sup>2</sup> Primary among the best practices is to annually or biennially obtain a reasonable Actuarially Determined Contribution (ADC). If they have not already done so, it is recommended that retirement boards and stakeholders make sure that funding policies are prioritized, documented, and periodically reviewed and amended.

### Funding Policy Background

A funding policy for a public sector defined benefit pension or OPEB plan is a systematic set of rules and procedures used to determine the annual funding contribution requirements to be made by the employer(s) in a specific year or a series of years. It should establish good governance procedures and discuss risk management among major areas of known pension or OPEB risks. Risks in this context are broadly those areas where there is a potential for loss or negative outcomes due to situations that may be manageable. There are also unknown risks and events that may occur and those will typically be dealt with on a case-by-case basis. In addition, a funding policy should address how, when, and by whom administrative and investment expenses are paid.

A full discussion of pension and OPEB risks is beyond the scope of this article. However, as a starting point, a pension plan can refer to ASOP No. 4 Section 3.19 and

<sup>1</sup>[https://www.actuarialstandardsboard.org/wp-content/uploads/2022/02/asop004\\_205.pdf](https://www.actuarialstandardsboard.org/wp-content/uploads/2022/02/asop004_205.pdf)

<sup>2</sup><https://www.gfoa.org/materials/core-elements-of-a-funding-policy>



also refer to the Low-Default-Risk Obligation Measure (LDRM) described in ASOP No. 4 Section 3.11.

Specifically, ASOP No. 4 Section 3.19 indicates a funding valuation should:

- a. Qualitatively assess the implications of the plan's funding policy on the plan's expected future contributions and funded status;
- b. Estimate how long before contributions are sufficient to minimally fund the normal cost plus interest on the unfunded actuarial accrued liability;
- c. Estimate the period over which the unfunded actuarial accrued liability will be fully amortized;
- d. Assess whether the funding policy is significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due and, if not, estimate the approximate time until assets are depleted.

For these reasons, plans need to establish or formally review their pension funding policies to formalize guidelines, objectives, and goals of the current and future retirement boards and stakeholders.

A funding policy can help achieve and sustain the long-term financial health of a pension or OPEB plan, especially by offering stability and guidance to decision making in periods of extreme economic volatility. A funding policy should be consistently applied, but it should also allow for the possibility of revisions should the need arise (which happens occasionally). Establishing and adopting a funding policy is one aspect of good governance.

In addition, the GFOA recommends "that every state and local government that offers defined benefit pensions and/or OPEB formally adopt a funding policy that provides reasonable assurance that the cost of benefits will be funded in an equitable and sustainable manner."

**A funding policy is a systematic set of procedures used to determine the plan's funding contribution requirements. Adopting a funding policy is good governance and is recommended by the GFOA.**

## Funding Objectives

The typical funding policy will detail the plan's funding objectives. Common funding objectives are benefit security, stable contribution rates, inter-period equity, funding progress, transparency, and agency risk controls. Benefit security, stable contribution rates, and inter-period equity (in particular) are often interrelated, yet possibly competing objectives.

## Funding Policy Core Elements

### CORE ELEMENTS OF A COMPREHENSIVE FUNDING POLICY

1. Actuarial cost method;
2. Asset smoothing method;
3. Amortization policy; and
4. Surplus management policy.

These elements should be reviewed on a regular basis in conjunction with actuarial experience studies and should be influenced by whether the plan is open, closed, or partially closed. In cases where there are insufficient assets to fund retiree liabilities, the funding policy should specifically address this as a top priority to resolve.

Broadly, there are two types of employer contribution approaches: 1) fixed (statutory) rate; and 2) variable (actuarially determined) rate. Approximately 32% of the largest defined benefit public pension plans in the United States are fixed rate plans or limit contributions requirements in some manner.<sup>3</sup> The focus of this paper applies to both fixed and variable rate approaches, but there will be less relevance for fixed rate plans when discussing the amortization policy. Both types of plans can identify unfunded liabilities by source for historical

<sup>3</sup>NASRA, "[Overview of Public Pension Plan Amortization Policies](#)," April 2022.



reference and more transparency if these are important objectives. Variable rate plans tend to have more discretion at the retirement board level compared to fixed rate plans. For more information on fixed rate plans, consider reading the American Academy of Actuaries Practice Note entitled “Fixed Rate Pension Funding.”<sup>4</sup>

To expand on the core elements of the funding policy:

- The **actuarial cost method** is the technique used to allocate the existing total present value of future benefits over the current employees’ working careers. A funding policy will include a description of how the actuarial accrued liabilities and the present value of future normal costs are determined. The actuarial cost method selected should comply with 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 benefit promises and address objectives, such as techniques to aid contribution stability and/or inter-period equity and/or benefit security. If level percentage of pay normal cost is one of the objectives, the entry age normal cost method is well suited for achieving this objective and is consistent with the requirements under GASB Standards for public sector financial reporting.

The actuarial cost method is used to allocate the active member present value of future benefits between the past and the future over the employees’ working careers. The entry age normal cost method is popular among public sector plans due to its level percent of pay characteristics. The retired member present value of future benefits is all allocated to the past.

- The **asset smoothing method** is the technique used to recognize gains and losses in pension or OPEB assets over time, which may help to reduce the effects of investment market volatility and help to stabilize

contributions. A funding policy will specify the asset smoothing period, whether it is open or closed, and often sets a market corridor, if any (which is the allowable amount of deviation between the funding value of assets and the market value of assets). The method used for asset smoothing should be unbiased relative to market. For example, it should:

- Use the same smoothing period for both gains and losses;
- Provide for smoothing to occur over fixed periods, typically from three to five years, but not longer than ten years to ensure scheduled convergence to the market value; and
- Provide for a symmetrical market corridor to avoid short term periods where the result of smoothing results in an unrealistic deviation from the market value.

Generally, the asset smoothing period is not long enough to influence inter-period equity, but it can negatively affect benefit security in the short term. For example, it could delay contributions compared to using a shorter asset smoothing period, a tighter corridor, or marking assets to market value.

The asset smoothing method “smooths” out market gains and losses relative to the assumed investment return, resulting in reduced contribution volatility for plans that have an actuarially determined contribution.

- The **amortization policy** establishes the length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded actuarial accrued liability. Specifically, an amortization policy will stipulate:
  - Whether there is a single amortization base or multiple (layered) amortization bases;
  - What determines the starting base amount(s) to be amortized;

<sup>4</sup>American Academy of Actuaries, Public Policy Practice Note, “[Fixed Rate Pension Funding](#),” February 2023.



- o Whether the plan is using a constant group size assumption;
- o What period each base is to be amortized over, is it by source, positive vs. negative, remaining active working lifetime, remaining life expectancy, dedicated revenue stream, funded status, or duration of the actuarial accrued liability;
- o Whether the level dollar or level percentage-of-pay method is used;
- o Whether a base is open or closed;
- o Whether a net amortization credit is used if the plan has an overall unfunded liability;
- o What is the treatment of the timing lag (if any) between the valuation date and the contribution period; and
- o What action should be taken if the plan becomes fully funded.

An amortization policy should include the manner in which the employer contribution is applied toward unfunded liability and how it will help achieve objectives such as volatility management (contribution stability and funded ratio progress) and/or inter-period equity and/or benefit security. It should also disclose if the unfunded actuarial accrued liability is expected to increase at any time during the amortization period or if the unfunded actuarial accrued liability is not expected to be fully amortized. Optimally, an amortization method should produce amortization payments that fully amortize each amortization base within a reasonable time period or reduce the outstanding balance by a reasonable amount each year.

The simplest amortization policy will amortize the entire unfunded liability over a single closed period using a single amortization base. Plans need to be mindful of the dramatic potential for increased contribution volatility as the amortization period shortens, particularly when it reaches five years or less. If an added degree of transparency is desirable, the sources of the remaining unfunded liability can be separated into as many bases as there are sources with

the sum of each of these calculations being the same as if all the bases were combined and amortized over a single period. The amortization payment for the unfunded liability could also be determined under two amortization methods (e.g., the unfunded retiree liability is funded using a level dollar approach and the remainder is funded using a level percent-of-payroll approach, with both amortization periods being the same).

A more complicated amortization policy will amortize various portions of the unfunded liability over different periods and possibly different methods. This is known as **layered amortization**. Approximately 73% of the largest defined benefit public pension plans in the United States are using layered amortization.<sup>5</sup> If using layered amortization, plans should consider if using the same amortization period is appropriate regardless of the magnitude or source of a new base. For example, if the amortization policy typically amortizes new credit or charge bases over 15 years, then the policy could amortize new bases over 3% of actuarial accrued liability over a longer period and amortize new bases under 0.5% of actuarial accrued liability over a shorter period.

The amortization policy stipulates how and when the unfunded liability will be amortized or paid off over time. The amortization policy is generally the element of a funding policy that needs routine evaluation in light of the plan's funding objectives.

- The **surplus management policy** will address how the plan will manage a funding surplus (i.e., assets greater than liabilities). It is important to understand and define the term "surplus." Surplus used in a pension or OPEB funding policy usually describes a temporary situation where assets are greater than liabilities according to current assumptions and methods. It does not represent a permanent amount that is available to repurpose. It should be carefully and prudently managed. Since assumptions, methods and benefit

<sup>5</sup>NASRA, "[Overview of Public Pension Plan Amortization Policies](#)," April 2022.



provisions can all change, and actual events can defy prediction, a surplus should not be treated as if there will be abundant resources in perpetuity. Rather a very deliberate and measured approach should always be used in the case of a surplus given the temporary nature of most surpluses.

Developing a surplus management policy before the plan enters surplus status will help decision makers avoid common pitfalls and problems when it happens.

Specifically, a surplus management policy will delineate:

- o Review procedures for key actuarial assumptions with a focus on reasonability and the level of risk inherent in each;
- o Evaluation of risk reduction strategies, which could include adding more conservatism to key actuarial assumptions and contemplating changes to the asset allocation policy in coordination with the investment consultant;
- o Consideration of how and under what circumstances contribution reductions would be allowed relative to the plan having no surplus (i.e., the minimum contribution might be the normal cost); and
- o Although the plan may have no control over benefit provisions, it can establish preferred conditions for proposed benefit changes, whether permanent or temporary, with prior knowledge and tentative agreement of the plan sponsor(s), including appropriate fiscal impact calculations on the plan for the near term and long term. It is highly recommended to produce long-term funding projections in order to assess the implications of decisions which may not be sufficiently illustrated by showing only the impact on the current or next valuation results.



## Actuarial Assumptions

To implement the funding policy core elements, it is necessary to have a set of actuarial assumptions. These assumptions are essential to the operation of a funding policy, even though they are not typically considered a core element. Within the funding policy, it is considered good practice to include the frequency of experience studies<sup>6</sup> and actuarial audits.<sup>7</sup>

In addition, the funding policy should be specific regarding the budgeted payroll used to determine the contributions and how this payroll is to be applied to the contribution results. Some factors to consider include:

- Is the contribution **rate** being applied? If so, to which payroll (e.g., biweekly, monthly, etc.)?
- Is a projected contribution **dollar** amount to be budgeted and contributed? If so, how often (e.g., biweekly, monthly, quarterly, etc.)? Will early or late contributions be credited or charged interest? If so, at what rate?
- If the contributions received are greater than the amount determined by the funding policy, how will they be treated (e.g., will they be used to pay down the unfunded liability, establish a prepaid employer contribution reserve, etc.)?
- If the contributions received are less than the amount determined by the funding policy, how will the shortfall(s) be collected (e.g., will a payable

<sup>6</sup>An actuarial experience study examines the differences between the plan's actuarial assumptions and actual experience over recent time periods (often three or five years) in order to review the trends and recommend changes to the assumptions and the four core elements. A comprehensive experience study would also review any other actuarial calculations such as actuarial equivalent option factors, service purchase calculations, and withdrawal liability calculations.

<sup>7</sup>In an actuarial audit, the plan hires an outside actuary to examine the work of the current actuary to monitor the accuracy and quality of actuarial services. It is essentially a second opinion which reviews some or all of the core elements of the funding policy as well as the assumptions and the most recent experience study.





amount be added to a subsequent contribution requirement, or amortized as part of an existing unfunded liability, or will a shortfall base be created and amortized over a shorter period, etc.)?

## Conclusion

Ultimately, a funding policy will be well worth the time and effort to create, maintain, and remind retirement boards and stakeholders how important the duties of trustees are with respect to the actuarial procedures employed and followed. A funding policy will help govern decision making that will lead to better financial outcomes and improved benefit security for all members of a public sector pension or OPEB plan.

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The authors thank Judith A. Kermans and Mary Ann Vitale for their review and helpful comments.

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