Working Draft 9-27-12

PENSION FUNDING GUIDELINES

Introduction

The Governmental Accounting Standards Board (GASB) has issued new standards for how state and local government employers should account for pension benefit costs. Significantly, the calculation of the employer pension expense will no longer be related to the employer funding requirements. Under this new approach, the GASB will require employers to report an actuarially determined annual required contribution (ARC) only if they voluntarily decide to calculate one. GASB will no longer set the parameters within which an employer calculates the ARC.[1]

Recognizing the need for action, the "Big 7" (National Governors Association, National Conference of State Legislatures, Council of State Governments, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and the International City/County Management Association), established a pension funding task force. In addition to representatives from the Big 7, the National Association of State Auditors, Comptrollers and Treasurers, Government Finance Officers Association, National Association of State Retirement Administrators, and National Council on Teacher Retirement serve on it. The Center for State and Local Government Excellence is the convening organization for the task force.

The task force has looked closely at work in progress by the actuarial community and is recommending that state and local governments **adopt a pension funding plan** that is designed around five general policy objectives, starting with an actuarially determined **annual required contribution (ARC)**.[2] The funding policy should address **three core elements**: (1) actuarial cost method; (2) asset smoothing; and (3) amortization policy.

Draft guidelines have been developed to identify both accepted and recommended practices for the systematic funding and consistent reporting of funding progress.

[1] The new GASB standards no longer use the term "annual required contribution " or "ARC". Instead, the new standards refer to the disclosure of an "actuarially determined contribution". However, these guidelines use the ARC terminology as it is already established in industry practice.

[2] Many public sector retirement systems have a fixed contribution rate that is set by statute or other legal guidance. Other systems determine contributions using other methodologies. Such systems should evaluate their contribution rates relative to their ARC determined in accordance with these Guidelines.

Recognizing that some accepted practices are more restrictive than current practice, the task force recommends that, if necessary, employers and retirement boards adopt a transition plan to phase in the new practices over a period of years. [3] The task force notes that these guidelines likely will be updated periodically to reflect changes in actuarial practice with regard to funding policy. Any actuarial funding policy should comply with the governing Actuarial Standards of Practice.

GENERAL POLICY OBJECTIVES

State and local governments should have a pension funding policy that is based upon an actuarially determined annual required contribution (ARC), and meets these five policy objectives in an integrated way. Governments likely will need to strike a balance between competing objectives and determine the most appropriate time frame in which to meet their goals.

- **Actuarially Determined Contributions.** A pension funding plan should be based upon an actuarially determined annual required contribution (ARC) that incorporates both the cost of benefits in the current year and the amortization of the plan's unfunded actuarial accrued liability.
- **Funding Discipline**. A commitment to make timely, actuarially determined contributions to the retirement system is needed to ensure that sufficient assets are available for all current and future retirees.
- **Intergenerational equity**. Annual contributions should be reasonably related to the expected and actual cost of each year of service so that the cost of employee benefits is paid by the generation of taxpayers who receives services from those employees.
- **Contributions as a stable percentage of payroll**. Contributions should be managed so that employer costs remain consistent as a percentage of payroll over time.
- **Accountability and transparency**. Clear reporting of pension funding should include an assessment of whether, how, and when the plan sponsor will ensure sufficient assets are available for all current and future retirees.

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[3] These Pension Funding Guidelines are developed for ongoing pension plans that provide a lifetime income according to a defined benefit formula based on the member's salary. Other funding policy consideration may apply to other types of plans, including terminated or frozen plans, retiree only plans, plans that have matched investment and benefit cash flows ("immunized" plans), retiree medical plans, other non-pay-related benefits and defined contribution plans. There are also some plan features that may require special consideration, including floor offset plans, cash balance plans and plans with "gain sharing" features.