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Model Legislation for Better Public Plan Governance (vs. Risk Disclosure)

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The Society of Actuaries (SOA) has been looking at ways to communicate the financial health and risks associated with public pension plans. This might be done by requiring actuaries to disclose items such as the ratio of plan assets to member payroll (which is a good simple measure of risk to the plan sponsor that is repeated often in this paper). The SOA's goal of improving the funded status of these plans is a good one. More disclosure will cause change but often not material change and sometimes not the types of change that some stakeholders¹ will want to see. For example, plan members often believe that disclosing liabilities not tied to the funding assumptions is intended to scare politicians into cutting benefits. In any case, dealing with plan health and risk requires more than actuaries disclosing numbers, since the biggest risks relate to governance, even when the material facts are known. A better solution is creating model legislation for plans to follow that encourages better governance. The funding of public pension funds can be improved by the creation of model legislation covering plan governance (i.e., the decisions made by boards of trustees and elected officials). Such a model would include required disclosures. The drafters of model legislation may be too political in their objectives; but in the end, while adopted by politicians, model legislation can be (if properly done) one of the best ways to ensure appropriate public policy guidelines for plan governance.

It is unquestionable that actuaries are asked to explain to stakeholders the health of a pension plan, its risks and the funded status of the plan. To best perform their job, actuaries must disclose more than numbers. They must internalize and express the “biggest risks” to the plan, which, especially in the public sector, often relate to plan governance. Model legislation can go beyond what just the actuary can do for a sometimes reluctant client. The suggestions in this paper for the construction of model legislation cover a wide array of governance issues but are not intended to be an exhaustive list. Only a unified approach identifying all key “risks” to plans will help prevent unnecessary benefit reductions, volatile rate increases or precipitous plan changes. This also requires, among other things, an honest evaluation of the distinction between best practices and minimum actuarial standards and how this distinction factors into writing standards, as is explained later in this paper.

In this paper, the focus is on the need for and scope of model legislation and the related risks model legislation can address. This is done by using examples showing certain types of bad governance (by different parties) that we should try to avoid.

¹ Stakeholders would include taxpayers and plan members. They would not include actuaries (who are service providers) or boards of trustees (who are agents of the stakeholders).

Recent legal debates have focused on whether and to what extent pension benefits can be reduced when the employer has problems obtaining funds to contribute to the plans or would rather spend available funds elsewhere or avoid raising taxes. We need to move on from that debate and focus on how new laws can be used to prevent underfunding and, to a limited extent, guide others when determining what is affordable (separate from a best practices model). This paper is not a legal analysis or an attempt to define what is “reasonable and necessary” to break a contract. The attorneys can still argue over what benefits are and are not protected.

Following are six questions that need to be debated and are covered in this paper. Woven throughout the discussion of these six questions are comments on how model legislation can help.

1. How much should we narrow existing funding practices?
2. Who should determine the assumptions, methods and contribution needs?
3. Is there a difference between normal best practices and minimum acceptable standards? (Maybe minimum acceptable standards should be defined as “best practices in troubled times”?)
4. How much risk is acceptable under a best practices model?
5. Who gets access to information and neutral (balanced) service providers?
6. What are some of the other items to consider in model legislation?

How Much Should We Narrow Existing Funding Practices?

The Conference of Consulting Actuaries (CCA) published a 2014 white paper going over in detail principles behind the setting of funding methods. The types of choices (and balancing of choices) discussed in the white paper should serve as the guide to answering this question. The CCA may consider or assist in drafting model legislation. If so, the CCA may focus on the actuarial aspects of proposed model legislation, namely the funding methods (covered by the white paper) and assumptions used by plans (not covered by the white paper). But this limited focus is understandable because the role of the actuary is limited. While actuaries have specialized financial knowledge that can assist their clients, they are not the fiduciaries who ultimately decide on funding and plan design. However, here are two reasons why the CCA paper on funding policies is so important:

1. It represents the opinions of many senior public plan actuaries, which makes it more difficult for a plan sponsor who hires an actuary to recommend something outside of preferred practice to defend the unusual recommendation, particularly when the recommendation is identified as “unacceptable” in the CCA white paper (e.g., open negative amortization).

2. It provides a replacement option for the former Governmental Accounting Standards Board Statement No. 27 (GASB 27) annual required contribution (ARC)² concept.

For these reasons, the white paper is a good place to start when answering the question of how much to narrow funding practices. However, if the white paper is not integrated with governance rules and combined with good assumptions, the desired results will be limited. Assumptions and methods are often not chosen by actuaries. Many are prescribed by boards or, legislatively, by plan sponsors. While actuarial standards may require the actuary to opine on the appropriateness of assumptions, assumptions are most frequently set by a political process and therefore subject to governance risks, which model legislation can address.

Who Should Determine the Assumptions, Methods and Contribution Needs?

This is a key area where model legislation can help.

The SOA Blue Ribbon Panel on Public Pension Plan Funding and many others realized that the main problem we face is the failure of employers to fund the ARC. In the private sector world (referred to as the ERISA world in this paper), this is rare (generally only in a bankruptcy situation) because of IRS and Pension Benefit Guaranty Corporation (PBGC) enforcement powers to mandate funding. In the public sector, there is often no way to force proper funding at the state level, and often the states place few or no effective requirements on local governments. The failure to contribute the ARC might be as blatant as not contributing the ARC calculated by the actuary, or it may be more subtly due to manipulation of assumption or method changes. This applies in more than one direction. For example:

1. For years City A failed to lower its discount rate to the level recommended by the plan's actuary. When City A did lower the discount rate (to a rate below what was recommended by the actuary), it failed to contribute more because soon after the assumptions were changed, benefits were cut and valuations (and ARCs) were revised.
2. City B continues to refuse to adopt recommended assumption changes to avoid contribution increases or benefit cuts.
3. State X has rules for what are called fixed-rate plans within that state. The idea is that if the current employer contribution rate cannot cover the normal cost and a 30-year amortization of the unfunded liability, then benefit changes need to be considered. In 201X, the City C plan (within State X) had an amortization period of just under 30 years. However, to accomplish this, the plan had to eliminate mortality improvement projections used in the prior valuation.
4. State Y provided annual ad hoc cost-of-living adjustments (COLAs) and funded them over 15 years. This kept the plan systemically underfunded.

² The new GASB term is the actuarially determined contribution (ADC). I use the term ARC, since it is more recognizable.

We must have enforceable rules to prevent these situations. Currently, retirees, employees, trustees and unions may not be able to successfully sue an employer simply for failing to fund a plan properly and may have to wait until contractual benefits are cut before suing the employer. This situation may occur if the courts cannot tell the legislatures how to allocate their budgets due to constitutional separation of powers concepts. Said differently, there needs to be an enforceable law that requires employers to adequately fund public plans. Current taxpayers and labor unions both can be reluctant to push for additional pension funding, since (1) taxpayers want lower taxes, (2) employees may prefer pay increases (particularly younger employees), and (3) there is a sense that, since the employer is responsible for the obligation, it will make good on its promises at some future time from future taxpayers (which may or may not be true). However, someone needs to look out for the future, and model legislation can help.

How can we prevent these situations? Here are three ways model legislation can help:

1. The simple presence of basic guidelines would be an improvement over annually looking for creative ways to justify unsound practices. States should create rules that govern both themselves and their local government plans. While there may be some differences, the basic rules should apply at both the state and local levels. There should be some model state oversight of local plans. Some states already have a set of rules covering state and local plans, but there is no common framework. National guidelines may provide elected officials notice of inappropriate practices and encourage the elected officials to reconsider rules that deviate from model legislation.
2. Rules should place control over hiring actuaries, setting assumptions and methods, and determining the ARC with independent boards of trustees. These functions should be separated from the plan sponsor. Some jurisdictions already have this arrangement. There may be little we can do when an employer fails to fund the ARC. However, the trustees have a fiduciary role. Model legislation can provide pressure and guidance to boards to request proper funding (and, if needed, provide a basis for legal action against the boards or the employers). It would be naïve to assume that all boards are unbiased, but this is the best option.
3. State rules should require and enforce adequate (but not necessarily best practice) funding. This includes creating member rights to adequate funding that can be enforced in the courts.

Is There a Difference Between Normal Best Practices and Minimum Acceptable Standards?

Yes, there is a difference. Goals for model legislation should be primarily focused on eliminating the worst practices. There needs to be room to accommodate differences of opinion and allow some flexibility in contributions. Not everyone is likely to agree what the term “model funding practice” means, and it may be plan design dependent (e.g., for a variable annuity plan, entry age normal funding is not a model funding practice). The

most conservative practice is not always the best practice (e.g., one-year amortization of investment losses might be most conservative but is not practical). There also needs to be a clear statement that employers cannot choose to reduce their contractual benefit obligations simply to implement model funding practices.

Consider the following proposal allowing for one type of flexibility:

Have model legislation that allows a phase-in of the increase in the contribution resulting from assumption changes using one of two options: (1) a phase-in of the assumption itself or (2) directly phasing in the contribution increase. When the actuary for City D recommended a drop in the discount rate³ (investment return assumption), the board decided to phase in the change by slowly lowering the discount rate (option 1). Boards tend to favor this option, since they feel that they are asking the state or municipalities to fully fund the ARC. A better solution (option 2) would be to have governance models that allow the phasing in of the cost of assumption changes (i.e., paying less than the ARC). Option 2 (also referred to as direct rate smoothing) has the following virtues: (1) it reduces the incentive to delay needed changes, (2) it can avoid the creation of a fiscal emergency where none existed, and (3) it shows liabilities and costs based on the ultimate set of assumptions. Option 1 has only the first two advantages. Having either type of phase-in should be acceptable as long as the phase-in is disclosed. Neither option falls under the CCA's white paper model practice (which is to not phase in the increase), and this is an example where model legislation should not require model practice.

Here is another example where model or best practices might be the goal but should not be the minimum standard for model legislation. Consider the following differences in amortization approaches that have occurred:

Situation #1: City E had a 20-year level dollar amortization policy. Unfortunately, much of the true unfunded liability had not been recognized. Shortly after assumptions were made more conservative (to recognize the true cost of the plan), benefits were cut deeply to allow for the current contribution rate to be roughly maintained without adopting a new amortization policy. The unions asked for fewer benefit cuts and a 25- or 30-year amortization period with level percentage of pay amortization, but no amortization changes were made.

Situation #2: In City F, again shortly after major assumption changes were made, benefit cuts were made (do you see a theme?). The benefit cuts came with a resetting (lengthening) of the level percentage of pay amortization period to 25 years. The benefit cuts and amortization changes effectively “funded” the first year’s cost of assumption changes by reducing the ARC to the preassumption change level. Again the unions asked for 30-year amortization to avoid some of the cuts, but the resetting to 25 years was used.

³ This concept is not limited to discount rate assumption changes.

A question to ask is: Why should City E be allowed to cut contractual benefits⁴ rather than make the type of changes taken by City F or those proposed by the unions? Model legislation should provide amortization over 15–25 years but force employers to adopt 30-year closed amortization (and get state approval) before considering other actions. There could be a debate about what employer financial differences should be present to allow for differences in funding requirements, but this is not an actuarial issue and most likely has no clear answer.

Finally, there will always need to be some type of transition rule. Plans currently using 30-year closed amortization periods should not be required to immediately cut the amortization period of the existing unfunded liabilities.

How Much Risk Is Acceptable Under a Best Practices Model?

There is a reason a paper about model legislation that is focused on minimum standards must talk about best practices in the area of risk. It is not that model legislation should require best practices in this area but rather to realize that (1) some decisions on risk tolerance go beyond model legislation and (2) models and markets are still evolving. There is no universal answer to the level of risk all plan sponsors can accept or how it can be determined. A discussion of risk can include the following three areas, only the first of which should be part of model legislation:

1. What is the best way to measure and communicate pension risk?
2. How much risk can an employer afford?
3. What is an employer's risk appetite (understanding that, all other things being equal, employers tend to avoid risk)?

Truly understanding risk goes beyond simple disclosures and what we can expect simple model legislation to cover. Model legislation should focus on the best way to measure and communicate risk. One simple measure of risk noted in the beginning of this paper is the ratio of assets to payroll. As this ratio increases, the impact of a swing in market returns increases the volatility in the contribution as a percentage of payroll. Most plans are still maturing by this measure. This implies that simply keeping an existing asset mix (e.g., 70 percent equities and 30 percent bonds) increases a plan sponsor's risk over time, even if this is not how annual risk is most commonly communicated by the plan's investment adviser.

How should good governance factor in risk and future risk trends? Decisions on affordability⁵ should be based on (1) the current cost of the plan, (2) the projected best

⁴ This drifts into the area of what is "reasonable and necessary" to allow for benefit cuts. However, model legislation should not define this. What is needed is flexibility in contributions that does not simply turn into always contributing the smallest possible amount.

⁵ Decisions on affordability and the employer's ability to pay are not ones that actuaries or trustees should be making. However, there are pension cost risks that the actuary can quantify.

estimate of future cost and, to a lesser extent, (3) a stochastic type of projection of possible future outcomes. Many employers would like to derisk their plans. In the public sector, that means that defined benefit formulas are reduced and possibly replaced with defined contribution plans. State X decided to derisk by adopting a more conservative investment mix, lowering its discount rate and paying for this by lowering benefits. Is the sponsor obligated to consider these risks early enough to avoid reducing benefits? A transition rule may need to be considered if we deal with future risk more than is common current practice.

A related question about investment policy statements: Should these policies self-adjust (i.e., reduce annual investment risk) as the plan matures? The ideal answer is yes, which would also imply that this is something the actuary should take into account now under a best practices model. However, over the last 20 years we have seen increases in both plan maturity and investment risk. Some of this is driven by real rates of return on bonds declining to virtually zero, adding to a preference for other asset classes. This makes the ideal answer somewhat less ideal. It also makes it difficult to include this in model legislation while allowing flexibility to react to market conditions.

At a minimum, model legislation should include requiring historical metrics such as the ratio of plan assets to payroll, as is being considered by the Actuarial Standards Board (ASB). A second round of refinements to model legislation can go further. Such refinements can specify useful projections. However, some projections are useless. For example, one often-quoted projection is when a plan will run out of money if the employer stops making unfunded liability payments. It is no surprise that if unfunded liability payments are not made that a plan will run out of money, and therefore there is no need to ask when this would occur. What this calculation does is imply that the employer has no responsibility for unfunded liabilities and moves the focus away from funding the benefit promises.

Who Gets Access to Information and Neutral (Balanced) Service Providers?

Asymmetric availability of (actuarial) information on public pension plans should be unacceptable. Actuaries usually work for the retirement boards. It is common, understandable and proper for the plan actuary to be asked to provide contribution projections to the board or employer. Retirement board websites tend to provide access to more information compared to what is available in other areas of actuarial practice. However, some boards are controlled by labor members, and many others by management members. There have been instances where key information was withheld from board members by executive directors and service providers. In a political environment, this type of activity is often not punished. We should have code of conduct rules for board members, staff and service providers. Model legislation should reduce the chance of continuing to hear from those responsible for the hidden (unshared) sins of the past: “It is not important how we got where we are. We need to move forward and fix things now.”

Often there is one actuary who performs the valuation and is relied on by all parties. Sometimes there are three actuaries: one for the board, one for the sponsor and one for the unions. The board should have only one actuary (subject to audits), but rules of communication need to be established. Should all work done by the plan actuary for an interested party other than the board be shared with the board? After a healthy debate, model legislation should address this.

Boards do not always have independent attorneys. There is also the human nature that the attorneys selected by boards (like actuaries) might favor the positions of the majority of board members. Many ERISA multiemployer boards hire two attorneys. In these ERISA plans, one attorney often does all of the heavy lifting, but both labor and management get to pick their own attorney, who is paid out of plan assets. While not an actuarial issue, legal advice representing both sets of stakeholder representatives should be addressed in model legislation.

It is also important to have an independent competent auditor who is familiar with pension rules. This has been lacking in the past for many plans.

What Are Some of the Other Items to Consider in Model Legislation?

Model legislation should also include a requirement that, before any benefit change is adopted, an actuarial study regarding the costs and risks of the change be prepared. (Note: Many jurisdictions already have this requirement, and this falls in the category of low-hanging fruit when this rule does not exist.) This is much more than just a best practice; it should be a minimum standard for model legislation. These studies are often prepared by the plan actuary, particularly when judgments on assumption changes are needed as a result of the proposed change (e.g., retirement rate changes due to changes in retirement eligibility). However, using the plan actuary for this work (1) often leads to questions about whether the plan should pay for these settlor functions and (2) often draws the plan actuary into the employer's sphere of influence. These factors should be addressed in model legislation.

As noted previously, those drafting model legislation should consider both best practices and minimum standards, and we believe they should focus on enforcing minimum standards. This will certainly lead to a debate with questions such as: (1) Should we draft minimum funding rules and hope that employers contribute more than the minimum? and (2) How sure are we that the minimum funding level will be the only contribution level most employers are likely to fund, given competing demands for funds? These questions and others should be part of a healthy debate.

A review of the Government Finance Officers Association (GFOA) best practices should be part of any discussion of model legislation, including actuarial and data audits and experience studies. Like the SOA work and actuarial standards, GFOA also has

disclosure recommendations. Again, model legislation does not always need to follow best practices.

There could be a debate about *disclosing* the sponsor's ability to change or reduce benefits. The time to resolve this debate is not now. Commentators to the GASB standards asked the GASB to require the employer to disclose this information. However, the GASB felt it inappropriate to do so because this issue is beyond the expertise of the auditors, who cannot easily audit the meaning of legal provisions. The problem for the auditor is that it requires legal expertise, and the law seems to be changing. What we thought was protected, we are not so sure about anymore. This leads to the concerns of the unions. Unions probably would have more easily supported better disclosure of employers' ability to change or reduce benefits 20 years ago than they would now, since the fear is that now employers will use the model legislation process to reduce benefit promises. Model legislation should not be used as an excuse to cut benefits. The law is too much in flux in this area to make now the time to include this in any model legislation.

If benefits are reduced, how much documentation should be prepared regarding the historical situation that resulted in the need to reduce benefits? What is the penalty for those who breached their fiduciary duty in the past? This can all be debated.

Should every rule proposed for model legislation be "back-tested" to see if it would have solved key problems in a state before it is adopted?

Who should draft such model legislation? It needs to be a diverse group—e.g., the GFOA, the National Association of State Retirement Administrators (NASRA), the CCA—with both legal and actuarial input.

Finally, drafting model legislation will not be easy. It is much harder to ask someone to regulate themselves than to regulate someone else. No one is going to like all the results of such a group effort, and putting together a balanced group of drafters will not be easy. Like when the group of actuaries created the CCA white paper on funding, it must be realized that not all existing policies can be accommodated. Yet, if this turns into a process to help employers eliminate these plans or to try to make the plans funded as if they were insurance companies, it should not be supported. One test of any proposal is whether it will reduce the likelihood that the trustees or the plan actuary will be used by one stakeholder against another, while still allowing improvements in governance and some flexibility. Refusing to try to create model legislation should not be an option. Whether to adopt the final outcome of this process is its own debate, once we know what we are debating.

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