Public Pension Plan Funding Policy

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Abstract

Description of Paper

While contributions to public defined benefit plans calculated under traditional actuarial methods are not necessarily sufficient to make a plan actuarially sound, the financial economics solution to the funding issue is worse than the problem. The traditional methods for public plan funding need to be improved. There is a need to establish rules for funding contribution calculations to strengthen the actuarial soundness of public plans. The rules would require plan sponsors to make progress towards full funding, without requiring full funding. At least for mature plans that are below 60 percent funded using the market value of assets (MVA), the amortization payment should be based on a descending amortization period, with a minimum amortization payment of the interest on the unfunded actuarial accrued liability (UAAL). The suggested improvements to traditional funding methods and assumptions include selecting a rate of return assumption that reflects the impact of volatility on the compounded return as well as accelerating the amortization of the UAAL. As a starting point for discussion, consideration should be given to a new funding method that would make the recommended contribution for funding purposes for public defined benefit plans subject to an overriding minimum contribution (OMC) calculation. The required contribution would be the greater of the amount determined using traditional methods and the OMC.

Key Items to be Covered

- Financial economics does not apply to public pension plan funding.
  - The Unit Credit Cost Method is unreasonable for pay-related plans.
  - Immediate amortization of gains and losses is unrealistic.

- Basing contributions on the change in the market value of liabilities (MVL) is too volatile.
- Not allowing smoothing of investment gains and losses for the actuarial value of assets (AVA) would produce an unacceptable level of volatility.
- The use of a risk-free discount rate would require an increase in contributions to an unacceptable level.

- Problems with traditional actuarial methods for public plan funding.
  - Perpetual negative amortization and unrealistic assumptions
  - Suggestions for improving the amortization methods.
  - Suggestions for selecting a best-estimate range for the investment return and payroll growth assumptions.
- Deriving the formula for the overriding minimum contribution (OMC).
  - The OMC would be a new funding method not already in existence.
  - The OMC is based on the normal cost plus a fraction of the benefit payments.
  - The fraction used in the OMC is based on the funded ratio using the MVA.
  - The OMC would avoid the problems with traditional methods that use inadequate amortization methods and excessive smoothing.
- Summary of suggested improvements to traditional methods for public plan funding.