

California Actuarial Advisory Panel
Discussion Draft: FUNDING POLICIES FOR PRICING BENEFIT CHANGES

Introduction and Overview

This discussion identifies approaches and issues to consider when negotiating benefits or determining the costs of potential changes in pension and OPEB benefits.

This discussion is developed in accordance with the following two **concepts** for basing policy discussions:

In order to build awareness, support, and trust by taxpayers, including the employees of public agencies, the process through which benefits are adopted, modified, and/or paid for needs to be open, transparent, and defensible.

The costs of promised benefits should be fully identified, known, and paid for within the working career of those receiving the benefit. The process for funding those benefits should be clear, easily understood, and actuarially sound.

In the particular context of pension benefit increases, these concepts lead to two basic **principles** for guiding the funding policies contained in this discussion:

1. The permanence and size of the funding source should generally balance or match the permanence and cost of the benefit increase.
2. The members who incur the cost of the benefit increase should generally balance or match the members who receive the advantage of the benefit increase. (This likely results in shorter amortization periods for prior service.)

The funding policies discussed in this discussion relate primarily to increases in pension plan benefits. To the extent that OPEB benefits are increased or decreased, most of these policies could also be applied.

Scope and Definitions

The cost of pension or OPEB benefit changes ultimately depends on the increased or decreased amount of benefits paid to members over time. However, the plan's funding policies determine the immediate impact on contributions as well as how any contribution changes will be allocated over future years. Also, contractual provisions can affect how cost changes are shared between the employer and the members, as well as how those benefit changes may relate to salary or other negotiated benefits.

- This discussion provides suggested approaches for funding both prospective and retroactive benefit increases using a variety of funding sources. This document considers the following sources of funding for benefit increases:
 - Using surplus to fund benefit increases
 - Linking benefit changes to changes in funding policy

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- Funding benefit increases with employer contributions
- Funding benefit increases with member contributions
- Pension benefit increases and salary increases in collective bargaining

The last section of this discussion also provides suggestions for providing adequate financial impact disclosures prior to the adoption of any benefit increases.

Following are definitions of some terms used in this discussion:

Prospective benefit improvements increase benefits only for service after some specified date. Also known as “future service” or “future service only” benefit increases.

Retroactive benefit improvements increase benefits only for service prior to some specified date. Also known as “past service” benefit increases. While most retroactive benefit increases include all past service, a retroactive benefit increase could apply only to a portion of a member’s past service.

Normal Cost is the portion of the total present value of benefits that is allocated to the current year of service for active members.

Actuarial Accrued Liability (AAL) is the value today of the past normal costs for active members, plus the full present value of benefits for retired and inactive members. It represents the total liability to date for all accrued costs for all members of the system [comment: we really need avoid linking the accrued liability to the accrued or promised benefit].

Actuarial Value of Assets (AVA) is the value of assets used when determining the employer contribution requirements. It is based on the market value of assets but in a way that reduces or “smoothes” short-term market volatility.

Unfunded Actuarial Accrued Liability (UAAL) is the difference, if any, of the plan’s actuarial accrued liability (AAL) compared to the plan’s actuarial value of assets (AVA). A plan with a UAAL must receive contributions in excess of the normal cost to achieve full funded status.

Surplus is the excess of the plan’s actuarial value of assets (AVA) compared to the plan’s actuarial accrued liability (AAL). A plan with a surplus may temporarily reduce contributions below the level of the normal cost.

Amortization is the process of paying off any UAAL or taking credit for any surplus over a period of years (the “amortization period”).

The employer contribution rate will generally be the sum of the normal cost plus any UAAL amortization payment (or less any surplus amortization credit), and less any member contributions.

Background

Historical Practice - California’s public sector pension benefits are generally set by some combination of statutory guidelines and collective bargaining agreements between the employer

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and employees. Historically, the cost of any improvements in the basic benefit formula was determined and allocated as follows:

- A prospective (future service) benefit increase usually causes an increase in future normal costs¹. Any corresponding increase in member contributions (either through bargaining or as required by statute) funds a portion of this increased normal cost.
- A retroactive (past service) benefit increase usually causes an increase in the UAAL, with an associated increase in the UAAL amortization cost. This cost was typically paid entirely by the employer¹. The immediate cost impact depends on the amortization period, with longer amortization periods producing lower immediate cost but paid over a longer period of time.
- Amortization periods for increases in UAAL due to benefit increases generally ranged from 15 to 30 years. Periods from 15 to 20 years represents the approximate working lifetime of the active members, while the 30-year period is the longest period allowed by applicable GASB standards.
- Note that a benefit increase for past and future service was treated as a combination of a prospective and retroactive increase, with increases in both normal cost and UAAL amortization. Any member contribution increases were based on and applied to only the increase in the normal cost.

Recent Changes - During the rise of the investment markets at the turn of the 21st century, there was considerable benefit improvement activity among California's pension systems. This has sometimes included various changes in the historical approaches to funding benefit increases as set out above, including the use of surplus, funding policy changes, and the application of member contributions.

Considerations and Suggested Approaches

The remainder of this discussion will identify and discuss a series of considerations that arise when pricing benefit increases, followed by suggested approaches for addressing each consideration in a manner consistent with the concepts and principles identified in the Introduction and Overview.

Consideration: Funding Periods for Retroactive (Past Service) Benefit Increases

Even though GASB rules allow increases in UAAL to be amortized over as long as 30 years, that period will generally be longer than the average working career of the members receiving the past service benefit increase. This means that some of the cost of the benefit increase will be borne by taxpayers who did not receive any services from the affected members. Typically, average future working lifetime is 12-15 years. Requiring shorter amortization periods for retroactive benefit increases means that the short term costs will be higher but that there will be little likelihood of an intergenerational cost shift.

¹ For example this happens under the Entry Age Actuarial Cost method if entry age, for the amount of the benefit improvement, is determined as the age benefits are improved.

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Furthermore, because most amortizations are a level percent of pay (rather than a level dollar amount), amortization periods generally longer than 18-20 years have a negative amortization for several years (this means the amortization payment is not sufficient to cover interest on the amount being amortized).

Suggested Approach

The total cost (increase in accrued liability) of retroactive benefit increases should be funded (amortized) over a period no longer than the average future working lifetime of current active members.

Consideration: Using a Surplus to Fund Benefit Increases

In the late 1990s, high levels of investment returns put many of California's public retirement systems into a surplus position. The amortization "credits" from these surpluses made the employer contribution levels fall below the normal cost. Furthermore, under the funding policies then in effect, these surpluses were being amortized over relatively short periods, with some systems (including CalPERS public agency valuations) using periods as short as five years. Under these policies, it did not take a very large surplus to produce an amortization credit that largely or entirely offset the normal cost, producing a "contribution holiday" for the employer.

These surpluses also had a significant impact on the immediate cost of benefit increases. This impact worked somewhat differently for the retroactive and prospective portions of a benefit increase, although the two were interrelated.

Retroactive benefit increases usually increase the UAAL and the associated amortization cost. However, because the plans had a surplus, any retroactive benefit increases instead reduced the surplus and the associated amortization credit. In effect the surplus was used to fund the increase in the actuarial accrued liability (AAL) caused by the retroactive benefit increase.

The market downturn in the early 2000s caused the assets of most plans to fall below the level of plan liabilities. Although this eliminated the plans' surpluses, any increases in actuarial accrued liability (AAL) due to previous benefit increases remained part of the plan's UAAL and associated amortization cost.

Suggested Approach

A surplus should not be used to fund retroactive benefit increases. Any increase in actuarial accrued liability due to retroactive benefit increases should be funded by an increase in future contributions.

Prospective benefit increases usually² cause just an increase in the long-term normal cost, regardless of the plan's funded status. However, for many plans during the late 1990s, surplus amortization credits were large enough to offset some or all of the increase in the normal cost as long as the surplus lasted (i.e., during the surplus amortization period).

² For example this happens under the Entry Age Actuarial Cost method if entry age, for the amount of the benefit improvement, is determined as the age benefits are improved.

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For example, for public agencies participating in CalPERS the following hypothetical scenario was not uncommon: While the normal cost of Plan A equals 10% of pay, because of a surplus, there were no required employer contributions and none expected to be required for the next 11 years. In this case, a benefit improvement cost study would show that, after the negotiated benefit increase took place, the new normal cost of Plan A would be 15% of pay. There were still no immediate employer contributions required, but with the benefit increases, employer contributions are projected to resume (at the higher normal cost level) in 6 years, rather than the original 11 years. CalPERS' communication discussed this. However, most employers did not understand what was happening, instead focusing on short term cash flow, which did not change making it look like the benefit improvement was free.

In this example, the surplus was used to "fund" the cost of the retroactive benefit increase as well as the first 6 years of the cost of the prospective benefit increase. It should be noted that in 2005 CalPERS changed its funding policy so that any future surpluses will be amortized over 30 years. This longer amortization period would have created much smaller annual surplus credits to offset required employer contributions.

Suggested Approach

A surplus should not be used to fund prospective benefit increases. Any increase in normal cost due to prospective benefit increases should be funded by an increase in future contributions with no corresponding change in the amortization period.

Consideration: Linking Benefit Changes to Changes in Funding Policy

On occasion, some retirement boards have conditioned funding policy changes to plan design actions by either the Governor, the Legislature, or an employer agency. The reverse may also be true—an employer may condition a plan design change on a retirement board taking action on a certain element of its funding policy. For example:

- Governor Deukmejian offered to sign a bill giving 1 year final compensation to state employees in exchange for the CalPERS Board's agreement to allow the State to stretch out its contribution to PERS in a year with a budget shortfall.
- In 1999, CalPERS' actuarial value of assets (AVA) was at around 90% of the market value. The CalPERS Board adopted a policy where the AVA would be increased to 95% of market value only for those agencies which adopted improved benefits. This change in funding policy had the result of reducing the immediate cost of a new benefit increase.
- In 2001, with the actuarial value of assets (AVA) close to 95% of the market value, the CalPERS Board adopted a policy of allowing employers who adopted new benefits the option of having their AVA increased to as high as 110% of market value. This action was taken in spite of the advice of both legal and actuarial staff that it was not a good idea.
- According to some reports, the retirement board for the City of San Diego changed city contribution requirements in exchange for benefit increases.

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Suggested Approach

Funding policies, including amortization periods and asset smoothing methods, should be determined separately from and independent of any proposed benefit improvements.

Consideration: Funding Benefit Increases with Member Contributions

Member contributions, both for existing benefits and for benefit improvements, are usually limited to some portion of the plan's normal cost, with the UAAL amortization paid entirely by the employer. In some cases, members have even bargained to pay for the entire normal cost increase associated with a benefit improvement, in effect paying for all of a future service benefit increase.

Recently, however, there have been some situations where members have agreed to pay some or all of the cost of a retroactive benefit increase, which means that the members are paying part of the UAAL amortization cost. Actuarially, this introduces a mismatch between costs and benefits that does not occur when members share only the prospective normal cost of the plan. The problem is that those close to retirement get the full benefit increase but pay little leaving either younger employees or taxpayers to pay the bill.

For prospective benefit increases, the normal cost is determined based on the future service of each member and is funded over those future years of service. This means that each member will be paying a portion of the normal cost for the same number of years to which the increased benefits will apply. This provides a match between the years of a new benefit being accrued with the years of increased contributions being paid by the member. In particular, future hires will receive the higher benefits and pay the higher contributions for their entire careers.

Suggested Approach

Active member contributions are generally an appropriate mechanism for funding prospective benefit increases.

For retroactive benefit increases funded from member contributions, there is no such alignment between the benefits received and the contributions paid. This leads to an inequity among different groups of members. Long service members who retire shortly after the retroactive benefit increase is implemented will receive a substantially increased benefit in exchange for minimal contributions, while those early in their careers receive relatively little benefit, if any, compared to the additional member contributions required over much of the duration of their career (for the length of the amortization period).

Suggested Approach

Active member contributions should generally not be used to fund the amortization of the UAAL. In particular, member contributions should not be used to fund retroactive benefit increases. Any increase in actuarial accrued liability due to retroactive benefit increases should be funded by an increase in future employer contributions.

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Consideration: Pension Benefit Increases and Salary Increases in Collective Bargaining

Pension benefit increases are often negotiated as part of an overall pay and benefits package. While other elements of the total compensation package may be part of any particular negotiation, for this purpose we will use a simplified situation where pension benefits and salary are the only elements of the bargained package, and salary concessions are being bargained in exchange for pension benefit increases.

For prospective benefit increases, the increased pension benefits and the salaries affect the same members over the same years, so the issue of inequity among different groups of members does not arise. However, there is a possible imbalance due to the relative permanence of pension benefits compared to salary levels.

Consider an example where the current normal cost is 10% of pay and a prospective benefit improvement would increase the normal cost to 15% of pay. Further suppose the employer has offered a salary increase in lieu of the pension increase of 15% over three years (5% raise per year). The agreement reached is to forego the first 5% salary increase in exchange for the new pension benefit.

While this is in balance at the outset and will remain so over the three year contract, it may not remain so indefinitely. Many years after the current contract, the pension benefit and the additional 5% normal cost will still be in place, but there may not be any mechanism to ensure that salaries continue to be 5% less than they otherwise would have been.

A simple solution is to have the entire increase in normal cost funded from additional member contributions. In this example, the members would receive all three 5% salary increases, and member contributions would increase by 5% of pay. This also has an advantage for the members since the additional 5% of pay will result in increased pension benefits through the final compensation calculation.

Suggested Approach

When prospective benefit increases are bargained in exchange for pay concessions, so that the intent is for the members to absorb the increased cost in lieu of pay increases, the increase in future normal costs should be funded from increased member contributions instead of foregoing pay increases.

For retroactive pension benefit increases, bargaining increased employer UAAL amortization costs in exchange for lower salary increases raises the same equity issues discussed above for using member contributions to fund the UAAL amortization. For example, the salaries of new hires may be lower than they would have been if not for the retroactive increase, even though the new hires did not share in the retroactive benefits.

One way to avoid this inequity is to match the value of the retroactive benefit increase with the value of the salary concession over the term of the bargaining agreement. This means that the amortization period for the increase in UAAL would be the duration of the bargaining agreement.

This may require that the retroactive benefit increases apply not to all years of past service, but instead to only a limited number of years. In effect each bargaining agreement would apply the

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salary concession from the period of that agreement to “upgrade” as many years of past service as the actuarial analysis will permit. This could be repeated in future bargaining agreements until benefits for all past service have been increased to the new target level or formula.

Suggested Approach

Bargaining parties should consider funding (amortizing) the cost of retroactive benefit increases only over the length of the bargaining agreement. Bargaining parties should consider adopting past service benefit increases only for as many years of service as can be funded by amortizing the UAAL over the same period as the bargaining agreement.

Consideration: Required Financial Impact Disclosures Prior to Adoption

Currently there is no standard format, content, or process for determining and presenting the cost of a pension benefit improvement. CalPERS has a report format that it uses for agencies requesting a benefit improvement cost study. Similarly, most independent retirement systems will have an actuarial study done at the request of an employer or bargaining parties. However, there is no statewide standard for content, level of detail, disclaimers, or risk analysis. In addition, an actuarial study may be provided to the bargaining parties, but those parties are then free to negotiate benefits with or without direct advice from the actuary. The level of financial detail required and the extent to which it is made available to the public also varies considerably.

As discussed, there are many components to funding benefit improvements, whether retroactive and/or prospective, including:

- Normal cost increase and UAAL amortization
- Member contributions vs. employer contributions

Suggested Approach

Any benefits increase proposals should be accompanied by a detailed cost analysis including but not limited to:

1. The increase in normal cost
2. The increase in actuarial accrued liability (AAL)
3. The amortization period for any increase in UAAL
4. The source(s) of funding for any increase in normal cost (as determined by the employer and/or employees)
5. The source(s) of funding for any increase in AAL (as determined by the employer and/or employees)
6. The net increase in employer cost and the expected duration of such increase
7. The net increase in employee contributions and the expected duration of such increase

Such disclosure should be noticed well in advance of any final contract settlement and made available to all interested parties.

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