California Actuarial Advisory Panel (CAAP) Model Funding Policies

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Agenda

CAAP Background

- California Public Employee Post-Employment Benefit Commission (PEBC)
  - Initially considered having Legislature set contribution limits
  - Recommendation 22 – Legislature should establish the California Actuarial Advisory Panel
- SB 1123 passed and signed September 2008

CAAP Purpose

- Impartial & Independent
- Information & Best Practices
- California Systems & Plan Sponsors
- Pension & OPEB
- No Statutory Authority

CAAP Model Disclosure Elements

- Actuarial Valuation Reports of Public Retirement Systems in California
- Recommendations:
  - Significant enhancements in reporting on risks associated with the funding
  - Disclosure beyond current reporting guidelines
  - Should make valuation reports more understandable and meaningful for readers.

CAAP

- Sent comments to GASB when issued Pension Statement Preliminary Views
  - Became clear GASB did not want to be in the business of setting contribution policy

GASB 68

- Recognize Net Pension Liability (asset) regardless of contributions
- Net Pension Liability drives Pension Expense
  - GASB 27 was the reverse
- Systems and plan sponsors need to look elsewhere for contribution out of bounds markers
  - Actuaries?
  - Big 7?
  - Legislature?
  - Plan Sponsors?
  - Common sense?
  - Some combination!

CAAP Funding Policy Development Process

- Started with development of general policy objectives:
  1. Benefits should be "fully" pre-funded
  2. Maintain generational equity
  3. Manage contribution volatility
  4. Support accountability and transparency
  5. Address principal/agent issues

CAAP Funding Policy Development Process

- Moved on to principal elements of actuarial funding policy
  - Cost (allocation) method
  - Asset smoothing method(s)
  - Amortization policy:
    - Period
    - Payment increases

CAAP Funding Policy Development Process

- Decided to categorize practices:
  - Model : Intended to refer to a specific funding model (LCAM). Not intended to be synonymous with "best" practices
  - Acceptable : "well established in practice … do not require additional analysis"
  - Acceptable, with conditions: "may be acceptable … to reflect different objectives or on the basis of additional analysis"
  - Non-recommended
  - Unacceptable
- Not intended as a grading or scoring mechanism

CAAP Funding Policy Guidance

- Document focus on how various policies do (or don't) achieve objectives
  - Actuarial cost methods
  - Asset smoothing
  - Amortization policy
  - Other (direct rate smoothing, etc.)

Funding Methods

- Preference for Entry Age Normal
- Other acceptable methods: PUC, EAN variations, Aggregate
- With conditions: Aggregate Entry Age

Asset Smoothing

- Preference for closed periods,
  - avoid long recognition periods with no corridor
- "Rolling" or "Asymptotic" also acceptable

Amortization Policies

- Preference for:
  - Layered, closed periods, with length of period dependent on source of UAAL
  - Level percentage of payroll if benefits pay-based
  - Avoid lengthy amortization of plan amendments
  - Longer amortization encouraged for surplus (but not only way to deal with surplus)
  - Use of these policies will generally result in discount rate = assumed return on assets for GASB purposes
- Rolling amortization of gains/losses also acceptable, but avoid long periods (negative amortization)
- New out-of-bounds markers: 25 is the new 30

California Actuarial Advisory Panel - Model Actuarial Funding Policies
Summary of Practice Categories

Practice Category	Actuarial Cost Method	Asset Smoothing Method	UAAL Amortization
Model	Entry Age cost method Level percent of pay "Funding to retirement age" Individually based Normal Cost Normal Cost based on current benefit structure ("replacement life" Entry Age)	Smooth actuarial gain or loss on market value (MVA) Fixed smoothing periods Maximum MVA corridors 5 years, 50%/150% corridor 7 years, 60%/140% corridor 10 years, 70%/130% corridor Combine smoothing layers only to avoid "tail volatility"	Layered fixed amortization periods by source of UAAL Level percent of pay amortization Amortization periods: Active or Inactive plan amendments: Demographic or up to 15 years Experience Gain/loss: 15 to 20 years Assumption / method changes: 15 to 25 years Early Retirement Incentives: 5 years or less Surplus: 30 years
Acceptable	Projected Unit Credit method Aggregate cost method, with Entry Age based disclosures Frozen Initial Liability method, with Entry Age Based disclosures Entry Age method with "Funding to Decrement" or with Normal Cost based on composite projected benefit	Five year (or shorter) smoothing with no corrider Rolling smoothing periods with model corridors plus additional analysis	Level dollar fixed period layered amortization with model amortization periods Rolling amortization of a single gain/loss layer with period that avoids negative amortization, with model periods for other sources of UAAL
Acceptable with Conditions	Aggregate Normal Cost variation of Entry Age cost method	15 years, 80%/120% corridor	Layered fixed amortization periods up to 25 years for all sources of UAAL Rolling amortization of a single gain/loss layer up to 20 years Rolling amortization of assumption/method changes (i.e., entire UAAL excluding plan amendments) with period that avoids negative amortization 30 year fixed amortization of method change or initial UAAL
Non-recommended	Entry Age with Normal Cost based on open tier ("Ultimate" Entry Age)	Longer than 5 year smoothing with no corridor	Layered fixed amortization periods from 26 to 30 years Rolling amortization of single gain/loss layer 21 to 25 years Rolling amortization of entire UAAL (excluding plan changes) with period that entails negative amortization Rolling amortization of entire UAAL (including plan changes) Single fixed amortization period, with periodic restarts
Unacceptable	Traditional Unit Credit for pay related plans	Longer than 15 year smoothing	Layered fixed amortization periods > 30 years Rolling amortization of a single gain/loss layer > 25 years Rolling amortization of entire UAAL > 20 years

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