# Funding Policy

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# Textbook Definition

- The plan sponsor's policy for determining the periodic contribution or cost for a plan.
- What does this mean?

# Many factors impact periodic plan cost or contributions

- Selection of actuarial methods
  - funding/cost methods
  - asset valuation methods
- Selection of actuarial assumptions
- Investment return and policy
- Frequency of contribution rate changes
- Benefit improvements
- Other policy factors

# Selection of Actuarial Methods

- The true cost of a pension plan emerges over time
  – actual benefits paid less actual investment return net of expenses.
- Actuarial funding and asset valuation methods allocate a plan's cost to the past and future.
- The allocation will differ under each set of actuarial methods.

# Selection of Actuarial Assumptions

- Used to estimate the amount and timing of future plan benefits.
- Investment return assumption used to calculate a present value of future benefit liabilities.
- Based on past experience and future expectations.
- Produces annual gains/losses, but should balance out over the long-term under a reasonable assumption.
- What is an appropriate level of conservatism?

# Investment Return and Policy

- The expected cost of a pension plan is:
  - the expected amount of future benefit payments less expected investment return net of expenses.
- The expected value of future investment return is model via a long-term assumption (static assumption).
- The assumption is set based on the plan's investment or asset allocation policy.

# Investment Return and Policy

- Expected plan liabilities/costs are reduced with higher expected returns (and higher expected investment risk).
- This so called “risk premium” is recognized up front in the present value calculation.
- Annual investment gains/losses relative to the assumption will produce rate volatility.
- Asset smoothing methods reduce this volatility by spreading this risk out over time.

# Frequency of Contribution Rate Changes

- How often should rates change?
- Fixed rates are stable, but may be inadequate in the long-term.
- Rates adjusted by the results of an annual actuarial valuation are adequate, but may not be that stable under certain funding policies.
- Ultimately, the frequency of rate changes is influenced by other funding policy decisions/factors.

# Benefit Improvements

- Today’s costs or contributions are based on today’s benefit levels.
- Future benefit increases will certainly increase costs above today’s levels.
- How do you best quantify and communicate the affordability of proposed benefit improvements?
- Short-term management of funding policy can lead to poor benefit policy decisions.

# Other Policy Factors

- Employee and employer cost sharing
- Intergenerational equity
- Benefit security
- Budgetary issues

# LEOFF 2 Funding Policy

- Aggregate funding method (in statute)
- Asset smoothing method (up to 8 years) with 30% market value corridor (in statute)
- Economic assumptions (in statute)
- Maximize returns at a prudent level of risk (WSIB mandate in statute)
- 2-year rate-setting cycle (in statute)

# LEOFF 2 Funding Policy

- Providing additional benefits to members and beneficiaries is the board's priority (in statute and strategic plan)
- Board shall manage the trust in a manner that maintains reasonable contributions and administrative costs (in statute)
  - Maintain the financial integrity of the plan (strategic plan)
- Costs are shared equally among members and employers/state (in statute)

# LEOFF 2 Funding Policy

- Minimum or floor contribution rate (adopted by formal board action)
- Stabilize contribution rates (strategic plan)
- Goal to maintain a funded ratio of at least 100% (target under strategic plan)
- Goal of intergenerational equity (in statute)
- Goal to continue to fully fund the plan (in statute)

# Questions/Observations

- The plan's current funding policy is a bit of a patch-work quilt
  - laws established prior to the board's creation
  - laws established via the initiative
  - formal board actions
  - board strategic planning
- Does the end result produce a funding policy that is consistent with the board's goals? Are there any gaps?

# Observations/Questions

- What is the best way to coordinate the plan's funding policy with the board's goals?
  – and what is most effective way to communicate that policy with your members?
- Why bother?
  – supports the board's strategic goals and statutory duties.
  – performance measurement under strategic plan.
  – helps manage stakeholder expectations.

# Coming Attractions

- Review, revise and adopt funding policies by 12/31/2005 (target under strategic plan)
- Board to receive the results of the 2004 actuarial valuation in October.
- PFC/Board may adopt changes to economic assumptions in the Spring of 2008.
- 2001-2006 full actuarial experience study in the Fall of 2008.