TEXAS PENSION
REVIEW BOARD

Guidance for Developing a Funding Policy
As required by Senate Bill 2224 (86R)
(Adopted October 17, 2019)

Texas Government Code §802.2011 requires **the governing board of a Texas public retirement system to adopt a written funding policy by January 1, 2020**. The policy is intended to be used as a retirement system's roadmap to fully fund its long-term obligations. The policy should be created with input from the system's sponsoring governmental entity whenever possible.

The funding policy is required to be filed with its sponsor and the Texas Pension Review Board (PRB) no later than the 31st day after the date the policy is changed or adopted.

A funding policy helps a system achieve the three fundamental goals of public pension funding: benefit security, contribution stability, and intergenerational equity. While different pension plans and their governmental sponsors may prioritize these goals differently, the funding policy should strive to **balance** these three primary pension funding goals so that member benefits are secure; employers and employees are afforded some level of contribution predictability from year to year; and liabilities are managed so that future taxpayers are not burdened with costs associated with a previous generation's service. For a more detailed discussion of the benefits of adopting a funding policy, please see the PRB's *2019 Interim Study: Funding Policies for Fixed-Rate Pension Plans*.

A funding policy should include the following components:

I. Clear and concrete funding objectives;
II. Actuarial methods;
III. A roadmap to achieve funding objectives; and
IV. Actions that will be taken to address actual experience that diverges from assumptions.

Components of a Funding Policy

I. Establishing Clear and Concrete Funding Objectives

A funding policy should clearly establish the retirement system's funding objectives. Per Government Code §802.2011, **the funding policy must target a funded ratio of 100% or greater.** The PRB recommends that systems adopt a funding policy that fully funds the plan **over as brief a period as possible**, with **10 – 25 years** being the preferable range, using a finite, or **closed, funding period**.

II. Selecting Actuarial Methods

An important role of a funding policy is to **set boundaries on what is allowable for actuarial calculations**. At a minimum, the three actuarial methods that should be addressed are the actuarial cost method, the asset-smoothing method, and the amortization policy.

Actuarial Cost Method	Asset Smoothing Method	Amortization Policy
An actuarial cost method is a way to allocate pieces of a participant's total expected benefit to each year of their working career. The most common actuarial cost method used in Texas, and the cost method required by GASB for financial reporting disclosures, is the entry age normal (EAN) method. Under the EAN method, benefits are assumed to accrue as a level percentage of pay over the period from the member's entry into the plan until his/her assumed termination or retirement. A funding policy should state the desired goals and purpose of the cost method if it does not specify the exact cost method to be used.	Asset smoothing techniques can help keep contributions stable and more predictable over time. Under smoothing, asset gains and losses are generally recognized over a period of years rather than immediately. A five-year smoothing period where 20% of any gain or loss is recognized in each subsequent year is typically used in Texas. The funding policy should specify the amount of return subject to smoothing (i.e. how much is deferred), the time period of the deferral, and if the smoothed value is subject to a corridor.	An amortization method is a procedure for determining the amount, timing, and pattern of recognition of a plan's gains and losses. Amortization amounts can be level dollar amounts or determined as a percentage of covered payroll. Level dollar amounts are preferable unless payroll is expected to decrease in the future. One approach that helps minimize annual contribution volatility while maintaining a finite, closed funding period is the use of layered amortization, where a single closed-period amortization base is established for each year's realized experience. Another approach is to establish closed-period amortization bases with varying recognition periods dependent upon the cause of a gain or loss. For example, one approach might be to amortize investment and/or actuarial experience gains or losses over a 5-year period, gains or losses attributable to assumption changes over a 10-year period, and gains or losses attributable to plan amendments over a 25-year period.

A funding policy may also include directions on how to account for expected plan administrative expenses, how often experience studies should be completed to maintain up-to-date demographic actuarial assumptions, and how to set the interest discount rate.

Negative Amortization

Negative amortization occurs when contributions are insufficient to cover the cost of benefits accrued and the interest accrued on the unfunded liability during the year. Plans should be careful in their use of negative amortization. If a plan's amortization policy results in negative amortization, the funding policy should outline the expected period over which negative amortization will occur and provide justification for the use of negative amortization.

III. Developing a Roadmap to Achieve Funding Objectives

A funding policy should provide a clear plan detailing how the system's funding goals will be met.

Contribution Rates

An actuarially determined contribution (ADC) structure requires the payment of an ADC rate. An ADC is defined as the cost of benefits earned by workers in the current year (the normal cost) plus an

amortization payment to recognize prior gains and/or losses. ADC contribution structures inherently adjust to the plan's changing funded status to maintain the overall trajectory towards fully funding benefit promises. This approach contrasts with fixed-rate funding structure which does not change from year-to-year unless proactive steps are taken.

If contributions are not made based on an ADC rate, the plan's governing body should establish and include the following items in the funding policy:

1. Determine an ADC that can be used as a benchmark to monitor whether the actual contributions are guiding the plan toward the stated funding objectives.

2. Establish what conditions will trigger action when the current actual contribution rate moves away from the benchmark ADC. For example, a certain funded ratio or difference between actual contribution and ADC could be used.

3. Identify tangible steps that will be taken to mitigate the differences between the actual and benchmark contribution rates, such as contribution and benefit changes. See Section IV for examples.

Benefit and Contribution Change Parameters

A funding policy should include elements designed to impede deviation from progress toward funding goals. This may be done by establishing parameters under which future benefit increases and contribution reductions can be considered.

Examples

A funding policy might state that:

➢ benefit enhancements can be made only if the funded ratio will remain at a certain level after the increase; or

➢ contribution reductions may only occur if a minimum amortization period is maintained.

IV. Adopting Actions to Address Actual Experience That Diverges from Assumptions

A funding policy should develop predetermined steps for how a plan should respond to **both positive and negative experiences that differ from the plan's assumptions**. The following methods can be used to manage funding risk.

Risk-Sharing

A funding policy should identify key risks faced by the plan and how those risks, and their associated costs, will be distributed between the employer and employees. This structure prevents one party from bearing all the risk in a funding policy. Often when there is no formal risk-sharing policy, benefit reductions or cost increases are imposed on employees, retirees or both after the plan's condition has deteriorated, rather than proactively, in advance, and in a manner transparent to members and stakeholders.[i]

Example: If investment returns are not as high as projected, the associated costs will need to be covered by additional contributions or benefit reductions distributed amongst members and the sponsor.

Contributions

A solution to ensure the plan meets its funding objectives is to require that the actual contribution rate is equal to or exceeds the ADC. If that is not achievable, the funding policy should identify what the trigger should be for a required adjustment to actual contribution rates. Techniques such as the following could be used to help move the actual contribution rate in the proper direction.

Contribution Corridor

Example: If the actual total contribution rate is within 2% of the ADC, no change is required. However, if the total contribution is more than 2% *over or under* the ADC, a change in contribution rates is required.

Maximum and Minimum Contribution Rates

Example: If the ADC exceeds a pre-determined maximum contribution rate, the funding policy may require the plan to adopt benefit changes. Conversely, if the ADC drops beneath a pre-determined minimum rate, the funding policy may require certain benefit increases, such as a COLA.

Contribution Smoothing

Example: If the actual total contribution rate needs to be increased by 2%, the rate could be increased in increments until the total contribution rate meets the ADC. Similarly, if the contribution rate needs to be decreased by 2%, the rate may be slowly decreased over time. The funding policy may state that the contribution rate may not increase or decrease by more than a given percentage each fiscal year.

Benefits

A funding policy may also establish when benefit adjustments will occur and include provisions that specify how both positive and negative experience will be addressed. Plans may allow for increased benefits or an increased COLA as a result of a positive deviation, but plans will need to ensure they are able to consistently meet the new funding demands of the changes.

Example: The funding policy could require that if sponsor contributions are increased, member benefits must be decreased in some proportional manner. Or, the policy may include provisions that grant a COLA to retirees if the funded ratio, after the benefit change, remains above a specified percentage. Caps may also be placed on maximum COLAs, or COLAs can be tied to inflation, to manage plan costs.

Examples of Funding Policy Components

Many pension plans across the United States have already adopted a funding policy, including several in Texas. Below are examples of components from those funding policies.

Component	Plan	Description
Benefit and Contribution Change Parameters	South Dakota Retirement System	The system may not consider **benefit improvements** unless the fair value funded ratio is and will remain after fully funding the cost of the improvement, over 120%.[ii] Proposed benefit improvements must be consistent with both the Board's long-term benefit goals and sound public policy with regard to retirement practices.
	City of Austin Employees' Retirement System	Employer **contribution** rate reductions should be considered only when annual COLA adjustments are built into funding assumptions and the funded ratio will remain greater than or equal to 105% after the reduction.[iii]
	City of Austin Employees' Retirement System	A **COLA** may be adjusted only when the adjustment can be financially supported; the funded ratio is $\geq$ 80% after incorporating the COLA; the amortization period is $\leq$ 20 years after incorporating the COLA; and the actual employer contribution rate is $\geq$ the ADC but no more than 18% after incorporating the COLA.[iv]
Contribution Smoothing	Fort Worth Employees' Retirement Fund	The contribution rate may not increase more than 2% of pay in one year or 4% in total to account for the ADC increase. If the maximum contribution increase has been applied and the actual contribution is still insufficient, the City Council must consider additional benefit reductions.[v]
Risk-sharing	South Dakota Retirement System	Should the funded ratio fall below 100% or if the fixed contribution rates are not sufficient to meet the actuarial requirement, the system is required to recommend corrective action, including benefit or contribution changes, in its annual report to the Legislature and Governor.[vi]
	Houston Firefighters' Relief & Retirement Fund Houston Municipal Employees Pension System Houston Police Officers' Pension System	The 3 Houston plans have a statutory funding policy that established a target contribution rate and a corridor around that rate. The plans and the City are required to take corrective action, including negotiating benefit reductions, if the recommended contribution falls outside the corridor.[vii]

Component	Plan	Description
Risk-sharing	Galveston Employees Retirement Plan for Police	Beginning January 1, 2025, if the actuarial valuation recommends an ADC that exceeds the aggregate (employee and City) contribution rate, the excess contribution will be split equally as a percentage of pay between the City and employee contribution rates.[viii]
	Maine Public Employees	COLAs are tied to investment returns. Reductions to COLAs may occur after severe market losses. The reductions will be removed once markets improve.[ix]
	Wisconsin State Retirement System	Retirement annuities are adjusted using a formula that factors in investment returns.[x]
	Pennsylvania State Employees' Pennsylvania Public School Employees'	The employee contribution rate increases or decreases based on investment plan returns.[xi]

Questions Systems and Sponsors Should Discuss During Funding Policy Development

The process of developing a funding policy presents an opportunity for a system's board of trustees to have an open, robust discussion of their priorities regarding the funding needs of the plan. The policy should be created with input from the system's sponsoring governmental entity whenever possible. The following checklist represents a set of fundamental questions trustees should consider during funding policy development but is not exhaustive.

☐ **Introduction**
- ☐ What is the purpose of the policy? What are we trying to achieve in this policy?
- ☐ How is the plan governed? What statutes or ordinances govern plan funding?
- ☐ What are our funding priorities?

☐ **Funding Objectives**
- ☐ Over what time period will we achieve 100% funding?
- ☐ How will we measure progress towards full funding? How will we measure if our funding objectives are being met?

☐ **Actuarial Methods**
- ☐ What valuation methods do we use to determine the ADC (or benchmark ADC)?
- ☐ How frequently should we calculate the ADC (or benchmark ADC)?
- ☐ How will we ensure we are meeting the ADC (or benchmark ADC)?
- ☐ Will we employ any asset smoothing methods? If so, what are they?
- ☐ What measures do our system and sponsor need to take to achieve 100% funding?
- ☐ How should we prepare for unanticipated changes?
- ☐ How frequently will actuarial experience studies occur?
- ☐ How is the interest discount rate determined?
- ☐ Is a negative amortization period ever acceptable, and if so, under what conditions?

☐ **Plan for Achieving Funding Objectives**
- ☐ How much money do we need today to pay for future promises?
- ☐ Will we use contribution smoothing methods? If so, what are they?
- ☐ What conditions must be met to adopt benefit increases or cost-of-living adjustments?
- ☐ What conditions must be met for contribution decreases to occur?

☐ **Risk Management Policy**
- ☐ What actions will we take should actual investment returns be less than the assumed investment returns used in the actuarial valuation? Should we consider action after a certain margin or threshold (positive or negative)?
- ☐ What actions will trigger changes to our assumptions at the next actuarial valuation?
- ☐ What conditions would trigger a contribution increase and what conditions must be met for contributions to return to their normal rate?
- ☐ Could we increase contributions temporarily?
- ☐ What conditions would trigger a review of our system's funding policy?

[i] Brainard, Keith, and Alex Brown, *In Depth: Risk Sharing in Public Retirement Plans. National Association of State Retirement Administrators*, January 2019, https://www.nasra.org/content.asp?contentid=124

[ii] South Dakota Retirement System, *SDRS Funding and System Management Policies*, https://sdrs.sd.gov/docs/SDRSFundingPolicy.pdf.

[iii] City of Austin Employees' Retirement System Benefits & Services Committee, *City of Austin Employee's Retirement System Board Approved Policy: Funding Policy and Guideline*s, 20142014. https://www.coaers.org/Portals/0/Resources/Publications/2-c%20F-2%20Funding%20Policy%20and%20Guidelines%202014-11-25.pdf?ver=2015-06-17-102341-677.

[iv] *ibid.*

[v] Employees' Retirement Fund of the City of Fort Worth, *Annual Actuarial Valuation*, 19 April 2019, p. 9, https://fortworthretirementtx-investments.documents-on-demand.com/?l=f419ce743442e5119795001fbc00ed84&d=64e81193956ae911a2cd000c29a59557.

[vi] South Dakota Retirement System, *SDRS Funding and System Management Policies*, https://sdrs.sd.gov/docs/SDRSFundingPolicy.pdf.

[vii] Retirement Horizons Incorporated, *City of Houston HMEPS Pension Reform Cost Analysis*,15 March 2017, https://www.houstontx.gov/pensions/public/documents/rhi-HMEPS.pdf.

[viii] H.B. 2763, 86th Texas Legislature, Regular Session, 2019, https://capitol.texas.gov/tlodocs/86R/billtext/pdf/HB02763F.pdf#navpanes=0

[ix] Maine Public Employees Retirement System, *Summary: PLD Plan Changes*, www.mainepers.org/Pensions/PLD%202018-Summary.htm.

[x] Brainard, Keith, and Alex Brown, *Shared-Risk in Public Retirement Plans. National Association of State Retirement Administrators*, June 9, 2014, p. 2, https://www.nasra.org/files/Issue%20Briefs/NASRASharedRiskBrief.pdf;
The Pew Charitable Trusts, *Cost-Sharing Features of State Defined Benefit Pension Plans: Distributing Risk Can Help Preserve Plans' Fiscal Health*, January 2017, p. 8, https://www.pewtrusts.org/-/media/assets/2017/05/definedbenefitplansreport.pdf.

[xi] *The Pew Charitable Trusts, Cost-Sharing Features of State Defined Benefit Pension Plans: Distributing Risk Can Help Preserve Plans' Fiscal Health, January 2017, p. 2, https://www.pewtrusts.org/-/media/assets/2017/05/definedbenefitplansreport.pdf.*