2013
PUBLIC SAFETY EMPLOYEES PENSION & BENEFITS CONFERENCE

100% Funding: Happy Days Are Here Again!

OR ARE THEY?

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Five Lessons in Public Safety Pension Funding

and the growing need for formal funding policy

Welcome to

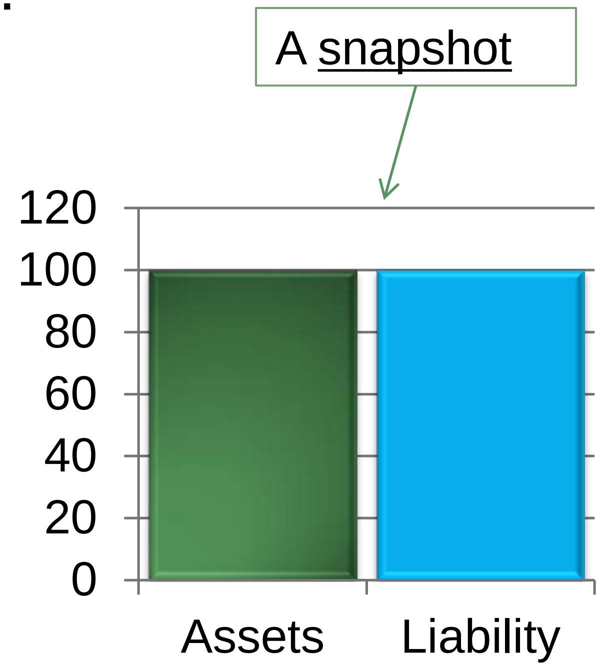
FULL FUNDING

The Temporary State

Lesson 1: Full Funding Is Not a Destination

WHAT IS "FULL FUNDING"?

- Assets *adequate* to meet obligations?
- No more contributions needed?
- The opposite of "unfunded"?
- The term is largely:
  - Misunderstood
  - Misused
  - A Misnomer



FUNDING IS A PATH, NOT A DESTINATION

Full Funding is Temporary

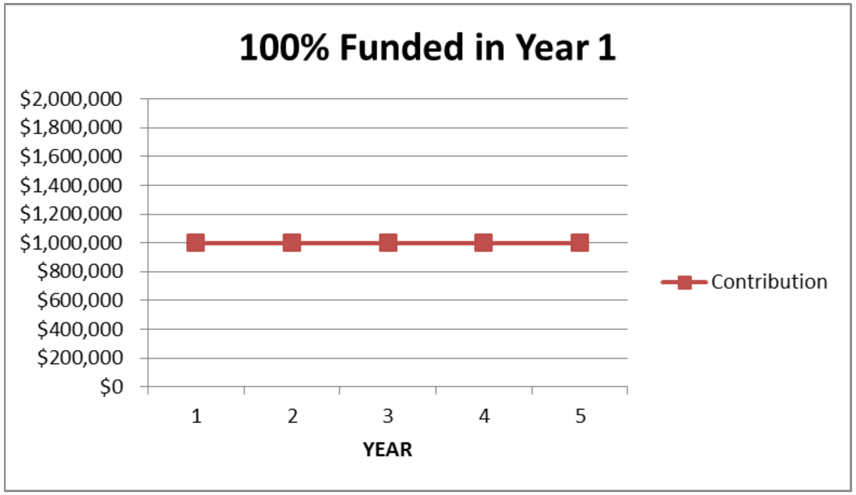
Lesson 2: Be Careful What You Ask For

What is wrong with 100%?

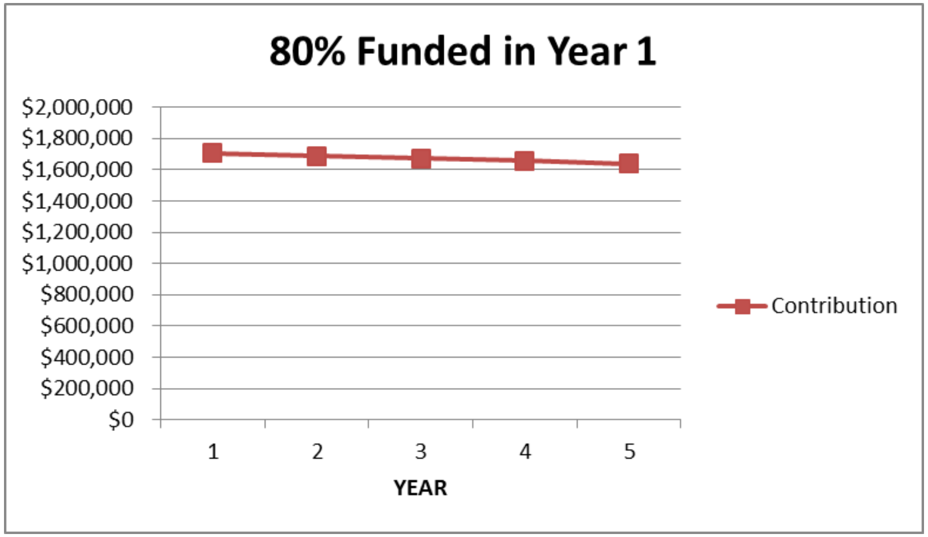
The Pros and Cons of 100% Funding

- First, what does it mean?
  - Actuarial Liability = Asset Value
  - Funding is ON TARGET (at <u>one point</u> in time)
- PROs
  - Looks good, feels good
  - Actuarial Cost = actual benefit cost (aka, Normal Cost)
  - No “unfunded” liability
- CONs
  - Times change
  - Risk of <u>overfunding</u>
  - Volatility - Contributions are extremely sensitive to gains/losses

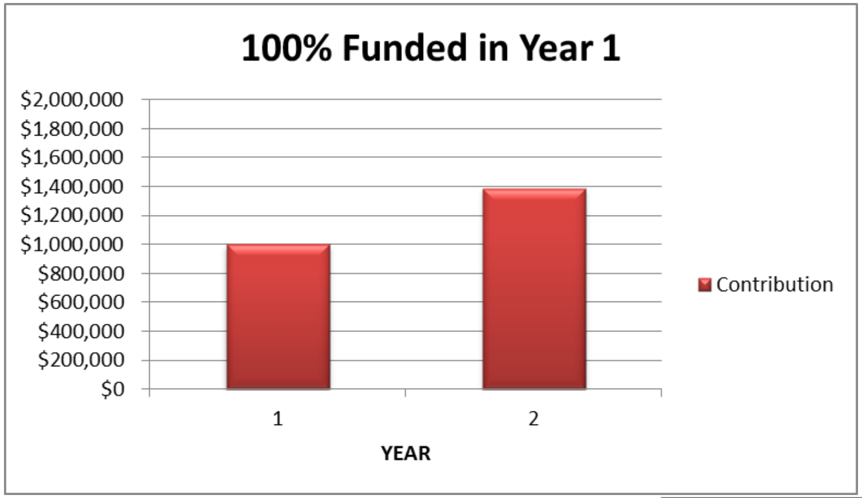
WHAT IS WRONG WITH 100%?



Scenario: No Gains or Losses



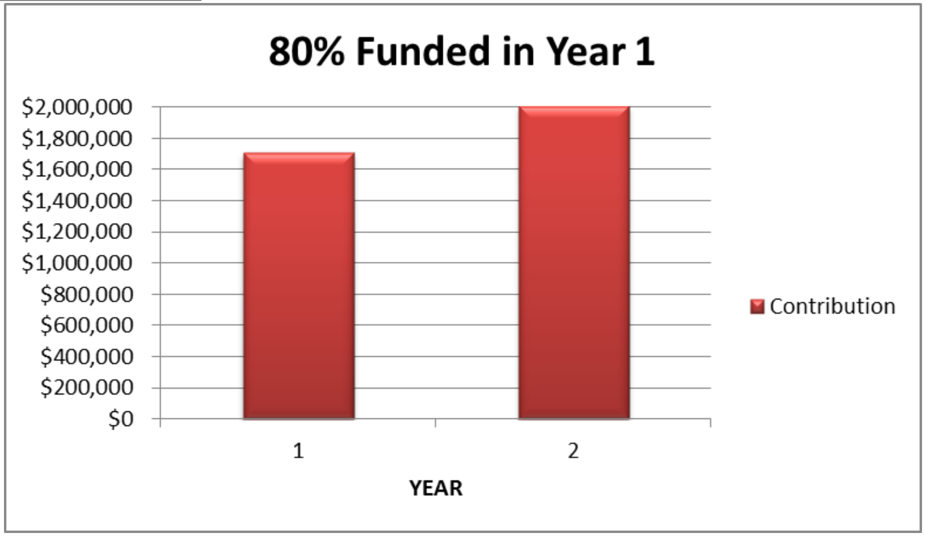
What is Wrong with 100%?



Scenario: 10% Actuarial Loss

← 40% Increase in Cost

18% Increase in Cost



Everything is <u>relative</u>

What is Wrong with 100%?

- The MOST volatile funding ratio is 100%
  - Small deviation from expected could mean large change in cost
- Stress testing will show a wide range of potential costs
  - In prior example, reasonable estimate for next year costs would be $0.6 to $1.4 million (a very wide range)
  - Budgeting becomes very challenging
- Some people will panic when ratio falls below 100%
- Actuarial funding policy is <u>crucial</u>
  - Need to address handling of “surplus” or shortfall

Lesson 3: Be Careful What You Spend

The problem with “Surplus” funding

THE PROBLEM WITH "SURPLUS" FUNDING

- When the plan is "overfunded" (>100%), it is off-target but in a good direction
- Should be viewed as part of the natural life cycle of a plan
  - There are ups. There are downs.
- Historically, there have been three reactions to "overfunding"
  1. Contribution Holidays
  2. Benefit Increases
  3. Continue funding Normal Cost
- In some cases both 1 & 2 applied; #3 was rare
  - Hindsight is 20/20

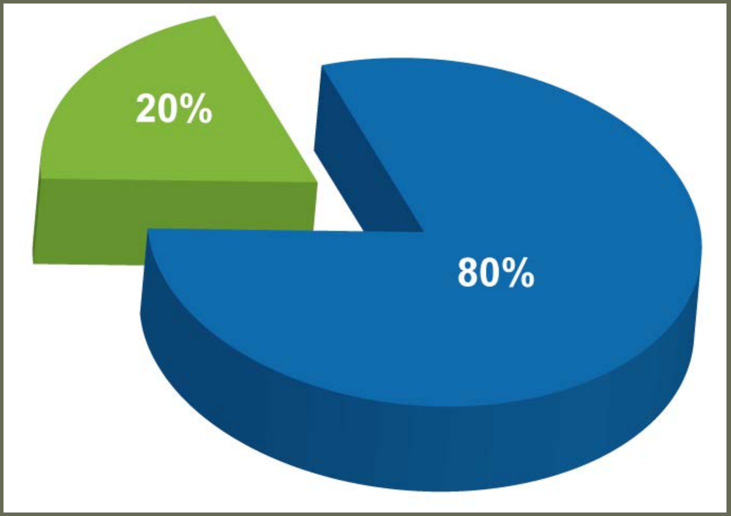
The Problem with "Surplus" Funding

- Contribution Holidays
  - If you are willing to contribute <u>nothing</u> in some years, then you should expect to contribute <u>double</u> in other years
    - Many/most plans are facing these cost levels now
- Benefit Increases
  - This is a one-way street – can be granted, but generally not "un-granted"
- Continue funding Normal Cost
  - A good idea, but what happens when the Plan is "severely overfunded" (e.g., 175%)?

The Problem with "Surplus" Funding

- Should there ever be contribution holidays?
  - Yes, BUT the circumstances under which a Holiday can occur should be clearly defined
- Should there ever be benefit increases?
  - Yes, BUT proceed with caution

Both should be addressed in Funding Policy
AND tested for consequences before making decisions



Lesson 4: 80% Is Not Magic, But…

What is the Deal with 80% Funding?

- 80% Funding = "somewhat off target"
- In a corporate pension plan:
  - 80% and 79% are very different
  - Laws governing these plans clearly deem 80% as a desirable funding level
- In most public plans, there is nothing official
  - Some states do have 80% triggers
- BUT, 80% is still perceived as healthy and desirable…

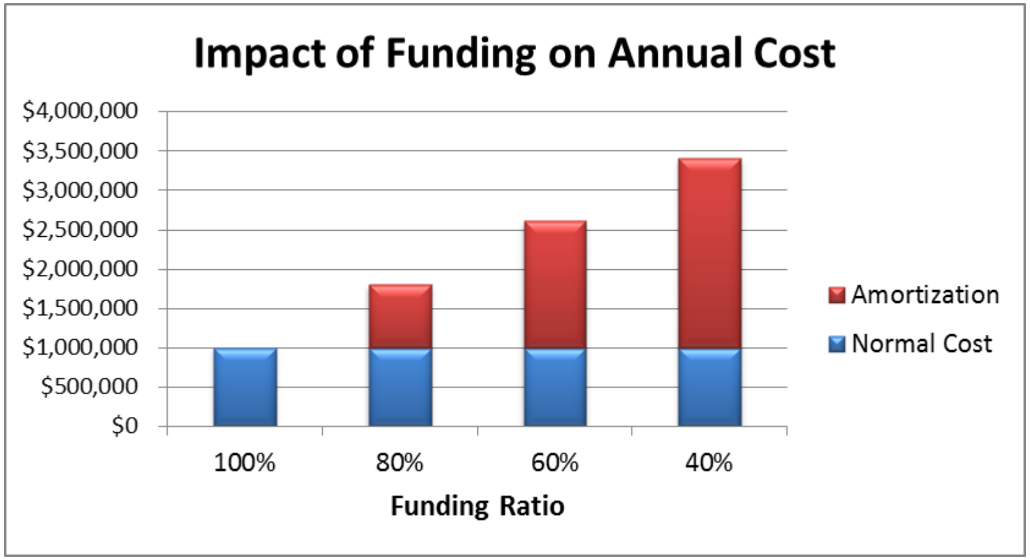
Why?

WHAT IS THE DEAL WITH 80% FUNDING?

- Is an 80% funding level good?
- Has been referred to as “adequate”, “healthy”, and/or “well-funded” by:
  - GAO, Pew, PERC (Pa), Stanford Institute, Bloomberg, various commentators and bloggers
- Part of this perception comes from corporate pension rules
- But part also makes sense:
  - It is appealing (80% is a grade of ‘B’)
  - Psychologically, it feels like 80%+ is “most of the way there”
- Funding Policy is number one way to move towards a desired funding level

What is the Deal with 80% Funding?

- There's something else…..



- 80% funding usually means an acceptable contribution level
  - Amortization cost still less than normal cost
  - Not the same for every plan

Lesson 5: Benefits Cost What They Cost

Conclusions

Conclusions

1. Full funding is temporary
2. Benefits cost what they cost: when funding is significantly off target, cost of benefits is distorted
3. Funding “surplus” is also temporary
4. 100% funding ain’t all it’s cracked up to be
5. 80% funding is not magic, but it does have some mojo
6. One number cannot possibly tell the whole story
7. **It is <u>essential</u> to understand implications of Funding Policy (and other policies) on <u>future</u> funding and contributions**

Funding Policy Considerations

ACTUARIAL	Cost Method
	Asset Smoothing
	Amortization
	Review of Assumptions/Policies
FUNDING	Contribution Timing/Frequency
	Progress Goals
	How to Manage Surplus, allow “holiday”?
	Strategy to Manage Volatility
OTHER	Reserve Accounts
	Integration with benefit policy
	Handling of Catastrophic Events (market crashes)

This list is not exhaustive.

THANK YOU!

- Greg Stump
- Please email any questions or comments to:
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