



Guidance for Developing a Funding Policy (Adopted TBD)

Overview

[Section 802.2011, Texas Government Code](#) requires **the governing board of a Texas public retirement system and, if the system is not a statewide system, its sponsor to jointly develop and adopt the same written funding policy and timely revise the policy to reflect any significant changes, including those made because of a funding soundness restoration plan (FSRP).** To jointly develop and adopt means that the governing bodies of both the system and sponsor should work together to develop, adopt, and review the funding policy periodically. The policy is intended to be a roadmap to fully fund the system's long-term obligations.

The funding policy requirement includes several components. By statute, the policy must be filed with the Texas Pension Review Board (PRB) no later than the 31st day after the date the policy is changed or adopted. The most recent version of the funding policy must also be available on a publicly available website.

A funding policy is required by law to be revised in a timely manner to reflect any changes a system and its sponsor make due to an FSRP. For purposes of a revised FSRP, the funding policy revisions must include any risk-sharing mechanisms, the adoption of an actuarially determined contribution structure, and other adjustable benefit or contribution mechanisms.¹ For more information about the FSRP requirement, including applicable statute, rules and policy, see the PRB's [FSRP webpage](#).

A funding policy helps a system achieve the three fundamental goals of public pension funding: benefit security, contribution stability, and intergenerational equity. Different retirement systems and their governmental sponsors may prioritize these goals differently, but the funding policy should strive to **balance** these three primary pension funding goals. Member benefits should be secure, employers and employees should be afforded some level of contribution predictability from year to year, and liabilities should be managed so that plan members and 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 clear and concrete funding objectives, actuarial methods, a roadmap to achieve funding objectives, and actions that will be taken to address actual experience that diverges from assumptions. The following material provides more detail on each of these necessary components of a funding policy. While this guidance uses examples of Texas retirement system funding policy provisions

¹ [Section 802.2011\(c\), Texas Government Code](#)

under various components, the use of such examples is for informational purposes and does not constitute endorsement or recommendation by the PRB.

Components of a Funding Policy

I. Establishing Clear and Concrete Funding Objectives

A funding policy should clearly establish the retirement system’s funding objectives. **The funding policy must target a funded ratio of 100 percent or greater and be jointly developed and adopted with the system’s sponsor.**² The PRB recommends that systems adopt a funding policy that fully funds the plan **over as brief a period as possible**, 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**. The system’s actuary should be involved with the development of a funding policy by advising the board on selecting actuarial methods that align closely with the system’s funding objectives, reducing volatility in returns, allowing a more predictable budget and increasing the likelihood of meeting obligations.³ 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
<p>An actuarial cost method is a way to allocate pieces of a participant's total expected benefit to each year of their working career.</p> <p>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.</p> <p>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 system until their assumed termination or retirement.</p> <p>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.</p>	<p>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.</p> <p>A five-year smoothing period where 20 percent of any gain or loss is recognized in each subsequent year is typically used in Texas.</p> <p>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.</p> <p>FSRP rules allow a system to use the greater of the market value of assets and the actuarial smoothed value of assets when determining</p>	<p>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.</p> <p>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.</p> <p>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</p>

² [Section 802.2011, Texas Government Code](#)

³ “Sustainable Funding Practices for Defined Benefit Pensions and Other Postemployment Benefits (OPEB)” *Government Finance Officers Association* 3, 5-7, approved March 3, 2023, <https://www.gfoa.org/materials/sustainable-funding-practices-for-defined-benefit-pensions>

	<p>the funding period to compare against the FSRP 30-year threshold.</p>	<p>over a five-year period, gains or losses attributable to assumption changes over a 10-year period, and gains or losses attributable to plan amendments over as short of a period as possible.</p> <p>A well-developed amortization policy will help a system maintain an amortization period below the 30-year statutory threshold and avoid triggering a funding soundness restoration plan.</p>
--	--	--

A funding policy may also include directions on how to account for expected system 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. Systems should be careful in their use of negative amortization. If a system’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 automatically adjust to the system’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 system’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 system 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:

- **TLFFRA system.** The board agrees that any benefit enhancements/changes to be submitted to the membership for vote will:
 - require that member contributions solely cover any increases to the ADC as a result of such benefit enhancements/changes, to the extent such sole coverage by members is permitted under TLFFRA statute; and
 - have been analyzed pursuant to the actuarial analysis process agreed to with the sponsor.
- **Municipal system.** Every two years, the board may review potential changes to the governing statute. The board may not recommend actions that result in a funding ratio less than 90 percent or an effective amortization period of over 15 years.
- **TLFFRA system.** The funding policy states that the board supports:
 - A reduction in the employer contribution rate only when the funding ratio would be above 105 percent and the total contribution rate is not less than the normal cost.
 - Benefit enhancements only if the amortization period is below five years, the resulting amortization period after reflecting the enhancements is above 10 years, and the average experience of three consecutive annual actuarial valuations must be used to evaluate actual fund status before any plan improvements can be brought to a vote.

Working With the Sponsor

A system and its sponsoring governmental entity are required to jointly create and approve the same funding policy. Working together will allow a system and its sponsoring entity to craft a funding policy that will achieve the system's objectives while maintaining agreed upon boundaries. Some Texas systems have established parameters like contribution levels or funding objectives in agreements with sponsors such as collective bargaining or meet and confer agreements.

Examples:

- **TLFFRA system.** The system and the sponsor use a Meet and Confer Agreement to establish certain responsibilities and funding goals shared by both parties. For example, the members agree to not raise benefits during the term of the agreement and the city agrees to only adjust contributions based upon an actuarial valuation.

Monitoring and Evaluation

A governing board should periodically review and revise their funding policy to better reflect the system's goals. A regular review policy could be adopted by the board by including a clause detailing the timeline or conditions for re-evaluating the funding policy using updated information from actuarial valuations and experience studies.

A board should proactively monitor its system’s financial condition. Monitoring requires that a board continually analyze investment returns, contributions, and benefits. A board can also establish actions to provide the system with a roadmap when it encounters adverse investment returns, unexpected member behavior, or other unforeseen events.

Examples:

- **Municipal system.** A committee of the board will review the policy at least every two years and make recommendations to the system’s full board necessary to maintain progress towards the goals and objectives in the funding policy.
- **Municipal system.** Actuarial experience studies are completed no less than every five years or at the board’s direction. The board will also review the funding policy in conjunction with the experience review.

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

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

Risk-Sharing

A funding policy should identify key risks faced by the system 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 system’s condition has deteriorated, rather than proactively, in advance, and in a manner transparent to members and stakeholders.⁴

There are multiple methods a system can utilize to implement a formal risk-sharing policy:

Total ADC Driven	Normal Cost Driven	Milestone Driven
Employee contributions are determined in relation to the ADC rate. Under this system, employees are given the most direct exposure to the system’s total experience. Systems can also decide the exact risk sharing ratio (i.e. 50/50, 60/40, etc). ⁵	Employee contributions are calculated in relation to the normal cost. This may result in a variable contribution rate. Employees are exposed to less risk due to their contributions not accounting for the system’s unfunded liability. ⁶	A system keeps employee contributions fixed until certain funding or investment thresholds are met. ⁷

⁴ 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>

⁵ Keith Brainard and Alex Brown, “In-depth: Risk Sharing Retirement Plans” National Association of State Retirement Administrators. 7-13, December 2018
<https://www.nasra.org/files/Spotlight/Risk%20Sharing%20in%20Public%20Retirement%20Plans.pdf>

⁶ Brainard and Brown, Risk Sharing

⁷ Brainard and Brown, Risk Sharing

Examples:

- **Municipal system.** The system's statutory funding policy established a target contribution rate and a corridor around that rate. The system and the city are required to take corrective action, including negotiating benefit reductions, if the recommended contribution falls outside the corridor.
- **TLFFRA system.** When the calculated amortization period deviates significantly from the benchmark ADC amortization period, the system and city will work together to implement a contribution rate that is reasonably close to the ADC. The rate increase will be no more than 2 percent of pay, can be phased in with two increases one year apart, and will initially be split equally between the members and city.

Contributions

A solution to ensure the system 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. If the contributions to the fund are consistently below the ADC, the fund becomes insolvent.⁸ 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 percent of the ADC, no change is required. However, if the total contribution is more than 2 percent *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 system 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*Examples:*

- If the actual total contribution rate needs to be increased by 2 percent, 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 percent, 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.
- **Statewide system.** The board sets aside investment reserves at its discretion to offset negative future returns. The reserves are not counted as a part of the participating employer's assets until the reserves are used.

⁸ "The Role of the Actuarial Valuation Report in Plan Funding" *Government Finance Officers Association*, Approved February 28, 2013, <https://www.gfoa.org/materials/the-role-of-the-actuarial-valuation-report-in-plan>

While the above techniques can stand alone, they are often included in risk-sharing provisions.

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. Systems may allow for increased benefits or an increased COLA as a result of a positive deviation, but systems 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. Alternatively, 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 system costs.

- **Municipal system.** Any benefit increase (including COLAs) may be adopted if:
 - The funded ratio of the system is above 80 percent after the benefit increase, and the decrease of the funded ratio is not more than 1 percent after the benefit increase.

The system also outlines provisions specifically for COLAs:

- The maximum amount of a COLA should not exceed the actual increase in the Consumer Price Index since the last COLA was granted.
 - A COLA will only apply to members who have been retired for over one year.
 - The board can choose to grant the COLA as a one-time payment or a monthly benefit increase.
- **TLFFRA system.** COLAs are tied to investment returns. The crediting rate for the COLA is lesser of the consumer price index or 100 percent of the five-year smoothed return minus 5 percent, not less than 0 percent, not greater than 4 percent.

Some factors to keep in mind when setting such parameters:

- Evaluating the impact of the plan provision on the amortization period and funded ratio after the plan provision takes effect, including whether the system will still meet its target date to reach full funding.
- Putting thresholds in place such that an increase can take effect only if the amortization period is below a specified threshold and the funded ratio is above a specified threshold after the benefit increases are factored in.
- Assessing whether the benefit increases are paid for by current active members to avoid passing down benefit costs to future generations.

Surplus Management

If a system is consistently funded at a rate above the ADC, there is a stronger likelihood of the system achieving a high funded ratio. A funding policy should include provisions detailing steps to follow if a system achieves full funding. A surplus management policy should include the following elements:

- Reviewing system risk management policies to evaluate their efficacy.
- Evaluating current assumptions to ensure reasonableness.

- Considering what changes should be made to employer and employee contributions (if any) when the system is in a surplus.
- Working with the sponsor to establish acceptable conditions for possible benefit enhancements, especially permanent ones, and provide accurate estimations for the immediate and long-term costs.⁹

Examples:

- **Municipal system.** If the system is overfunded, the surplus will be amortized over an open amortization period of 30 years.
- **Statewide system.** If the system is overfunded, all prior bases are erased, and one surplus base would be established. The asset surplus is used to generate a contribution credit for the year that is projected to remain the same over time and keep the funded ratio constant year over year. This practice reduces contribution rate volatility.

DRAFT

⁹ “Core Elements of a Funding Policy for Governmental Pension and OPEB Plans” *Government Finance Officers Association*, approved March 23, 2023, <https://www.gfoa.org/materials/core-elements-of-a-funding-policy>

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 system. 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 often should we review the funding policy?
- How is the system governed? What statutes or ordinances govern system funding?
- What are our funding priorities?

Funding objectives

- What is the target date to achieve 100 percent 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 percent 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 for contribution decreases to occur?

When to allow benefit increases

- What conditions must be met to adopt benefit increases or cost-of-living adjustments?
- What will the impact of the benefit increase be on the amortization period and funded ratio?
- Will the system still meet its target date to achieve full funding?
- Will the resulting amortization period be less than the average remaining future service for current active members?
- Will the resulting funded ratio be above the system's desired threshold?

Contribution distribution between members and city

- Will members contribute appropriately for the level of benefits received?

- Is there a target employer normal cost as percent of pay (total normal cost percent less employee contribution percent)?
- 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?
- Surplus management policy**
 - What actions will we take should the system receive funding over the ADC?
 - What actions will we take when the system exceeds 100 percent funding?

DRAFT

Redline Copy Showing Changes
from Original Document



Guidance for Developing a Funding Policy

As required by Senate Bill ~~2224~~ (86R)

(Adopted ~~October 17, 2019~~TBD)

Overview

~~Section 802.2011, Texas Government Code §802.2011~~ requires the governing board of a Texas public retirement system **and, if the system is not a statewide system, its sponsor** to **jointly develop and adopt the same** written funding policy ~~by January 1, 2020~~ and **timely revise the policy to reflect any significant changes, including those made because of a funding soundness restoration plan (FSRP).** To **jointly develop and adopt** means that the governing bodies of both the system and sponsor should work together to develop, adopt, and review the funding policy periodically. The policy is intended to be ~~used as a retirement system's~~ a roadmap to fully fund ~~its~~the system's 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~~requirement includes several components. By statute, the policy must 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. The most recent version of the funding policy must also be available on a publicly available website.

A funding policy is required by law to be revised in a timely manner to reflect any changes a system and its sponsor make due to an FSRP. For purposes of a revised FSRP, the funding policy revisions must include any risk-sharing mechanisms, the adoption of an actuarially determined contribution structure, and other adjustable benefit or contribution mechanisms.¹ For more information about the FSRP requirement, including applicable statute, rules and policy, see the PRB's FSRP webpage.

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~~Different retirement systems and their governmental sponsors may prioritize these goals differently, but the funding policy should strive to **balance** these three primary pension funding goals ~~so that member, Member~~ benefits ~~are~~should be secure; employers and employees ~~are~~should be afforded some level of contribution predictability from year to year; and liabilities ~~are~~should be managed so that plan members and 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:~~

¹ [Section 802.2011\(c\), Texas Government Code](#)

- I. ~~Clear~~clear and concrete funding objectives;
- II. ~~Actuarial~~actuarial methods;
- III. ~~A~~a roadmap to achieve funding objectives;² and

~~Actions~~actions that will be taken to address actual experience that diverges from assumptions. The following material provides more detail on each of these necessary components of a funding policy. While this guidance uses examples of Texas retirement system funding policy provisions under various components, the use of such examples is for informational purposes and does not constitute endorsement or recommendation by the PRB.

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~~The funding policy must target a funded ratio of 100% percent or greater, and be jointly developed and adopted with the system’s sponsor.² 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.** The system’s actuary should be involved with the development of a funding policy by advising the board on selecting actuarial methods that align closely with the system’s funding objectives, reducing volatility in returns, allowing a more predictable budget and increasing the likelihood of meeting obligations.³ 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
<p>An actuarial cost method is a way to allocate pieces of a participant's total expected benefit to each year of their working career.</p> <p>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.</p> <p>Under the EAN method, benefits are assumed to accrue as a level</p>	<p>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.</p> <p>A five-year smoothing period where 20% <u>percent</u> of any gain or loss is recognized in each subsequent year is typically used in Texas.</p>	<p>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.</p> <p>One approach that helps minimize annual contribution volatility while maintaining a finite, closed funding period is the use of layered amortization, where a single</p>

² Section 802.2011, Texas Government Code

³ “Sustainable Funding Practices for Defined Benefit Pensions and Other Postemployment Benefits (OPEB)” *Government Finance Officers Association* 3, 5-7, approved March 3, 2023, <https://www.gfoa.org/materials/sustainable-funding-practices-for-defined-benefit-pensions>

<p>percentage of pay over the period from the member's entry into the <u>plansystem</u> until <u>his/her/their</u> assumed termination or retirement.</p> <p>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.</p>	<p>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.</p> <p><u>FSRP rules allow a system to use the greater of the market value of assets and the actuarial smoothed value of assets when determining the funding period to compare against the FSRP 30-year threshold.</u></p>	<p>closed-period amortization base is established for each year's realized experience.</p> <p>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 <u>5five</u>-year period, gains or losses attributable to assumption changes over a 10-year period, and gains or losses attributable to plan amendments over <u>as short of a 25period as possible.</u></p> <p><u>A well-developed amortization policy will help a system maintain an amortization period below the 30-year period-statutory threshold and avoid triggering a funding soundness restoration plan.</u></p>
--	--	---

A funding policy may also include directions on how to account for expected plansystem 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. PlansSystems should be careful in their use of negative amortization. If a plan'ssystem'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 inherentlyautomatically adjust to the plan'ssystem'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'ssystem'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 plansystem 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 **TLFFRA system**. The board agrees that:

- any benefit enhancements ~~can/changes to~~ be ~~made only if~~ submitted to the funded ratio membership for vote will remain at a certain level after the increase; or:
 - require that member contributions solely cover any increases to the ADC as a result of such benefit enhancements/changes, to the extent such sole coverage by members is permitted under TLFFRA statute; and
 - have been analyzed pursuant to the actuarial analysis process agreed to with the sponsor.
- **Municipal system**. Every two years, the board may review potential changes to the governing statute. The board may not recommend actions that result in a funding ratio less than 90 percent or an effective amortization period of over 15 years.
- **TLFFRA system**. The funding policy states that the board supports:
 - A reduction in the employer contribution rate only when the funding ratio would be above 105 percent and the total contribution rate is not less than the normal cost.
 - Benefit enhancements only if the amortization period is below five years, the resulting amortization period after reflecting the enhancements is above 10 years, and the average experience of three consecutive annual actuarial valuations must be used to evaluate actual fund status before any plan improvements can be brought to a vote.

Working With the Sponsor

A system and its sponsoring governmental entity are required to jointly create and approve the same funding policy. Working together will allow a system and its sponsoring entity to craft a funding policy that will achieve the system's objectives while maintaining agreed upon boundaries. Some Texas systems have established parameters like contribution levels or funding objectives in agreements with sponsors such as collective bargaining or meet and confer agreements.

Examples:

- **TLFFRA system**. The system and the sponsor use a Meet and Confer Agreement to establish certain responsibilities and funding goals shared by both parties. For example, the members

agree to not raise benefits during the term of the agreement and the city agrees to only adjust contributions based upon an actuarial valuation.

Monitoring and Evaluation

A governing board should periodically review and revise their funding policy to better reflect the system's goals. A regular review policy could be adopted by the board by including a clause detailing the timeline or conditions for re-evaluating the funding policy using updated information from actuarial valuations and experience studies.

A board should proactively monitor its system's financial condition. Monitoring requires that a board continually analyze investment returns, contributions, and benefits. A board can also establish actions to provide the system with a roadmap when it encounters adverse investment returns, unexpected member behavior, or other unforeseen events.

- ~~➤ Examples: contribution reductions may only occur if a minimum amortization period is maintained.~~
- **Municipal system.** A committee of the board will review the policy at least every two years and make recommendations to the system's full board necessary to maintain progress towards the goals and objectives in the funding policy.
- **Municipal system.** Actuarial experience studies are completed no less than every five years or at the board's direction. The board will also review the funding policy in conjunction with the experience review.

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

A funding policy should develop predetermined steps for how a ~~plan~~system should respond to **both positive and negative experiences that differ from the ~~plan's~~system'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~~system 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.~~³

Example: If investment returns ~~system's~~ condition has deteriorated, rather than proactively, in advance, and in a manner transparent to members and stakeholders.⁴

⁴ 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>

There are not as high as projected, the associated costs will need multiple methods a system can utilize to be covered by additional contributions or implement a formal risk-sharing policy:

<u>Total ADC Driven</u>	<u>Normal Cost Driven</u>	<u>Milestone Driven</u>
<u>Employee contributions are determined in relation to the ADC rate. Under this system, employees are given the most direct exposure to the system’s total experience. Systems can also decide the exact risk sharing ratio (i.e. 50/50, 60/40, etc).⁵</u>	<u>Employee contributions are calculated in relation to the normal cost. This may result in a variable contribution rate. Employees are exposed to less risk due to their contributions not accounting for the system’s unfunded liability.⁶</u>	<u>A system keeps employee contributions fixed until certain funding or investment thresholds are met.⁷</u>

Examples:

- **Municipal system.** The system’s statutory funding policy established a target contribution rate and a corridor around that rate. The system and the city are required to take corrective action, including negotiating benefit reductions distributed amongst, if the recommended contribution falls outside the corridor.
- **TLFFRA system.** When the calculated amortization period deviates significantly from the benchmark ADC amortization period, the system and city will work together to implement a contribution rate that is reasonably close to the ADC. The rate increase will be no more than 2 percent of pay, can be phased in with two increases one year apart, and will initially be split equally between the members and the sponsor.

⁵ Keith Brainard and Alex Brown, “In-depth: Risk Sharing Retirement Plans” National Association of State Retirement Administrators. 7-13, December 2018

<https://www.nasra.org/files/Spotlight/Risk%20Sharing%20in%20Public%20Retirement%20Plans.pdf>

⁶ Brainard and Brown, Risk Sharing

⁷ Brainard and Brown, Risk Sharing

city.

Contributions

A solution to ensure the plansystem 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. If the contributions to the fund are consistently below the ADC, the fund becomes insolvent.⁸ 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% percent of the ADC, no change is required. However, if the total contribution is more than 2% percent 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 plansystem 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

Examples:

- ~~Example:~~ If the actual total contribution rate needs to be increased by 2% percent, 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% percent, 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.
- Statewide system. The board sets aside investment reserves at its discretion to offset negative future returns. The reserves are not counted as a part of the participating employer's assets until the reserves are used.

While the above techniques can stand alone, they are often included in risk-sharing provisions.

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. PlansSystems may allow for increased benefits or an increased COLA as a result of a positive deviation, but planssystems 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~~ Alternatively, the policy may include provisions that

⁸ "The Role of the Actuarial Valuation Report in Plan Funding" *Government Finance Officers Association, Approved February 28, 2013*, <https://www.gfoa.org/materials/the-role-of-the-actuarial-valuation-report-in-plan>

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 plansystem costs.

DRAFT

Examples of Funding Policy Components

- Many pension plans across **Municipal system**. Any benefit increase (including COLAs) may be adopted if:
 - The funded ratio of the ~~United States~~ system is above 80 percent after the benefit increase, and the decrease of the funded ratio is not more than 1 percent after the benefit increase.

The system also outlines provisions specifically for COLAs:

- The maximum amount of a COLA should not exceed the actual increase in the Consumer Price Index since the last COLA was granted.
 - A COLA will only apply to members who ~~have already adopted a~~ been retired for over one year.
 - The board can choose to grant the COLA as a one-time payment or a monthly benefit increase.
- **TLFFRA system**. COLAs are tied to investment returns. The crediting rate for the COLA is lesser of the consumer price index or 100 percent of the five-year smoothed return minus 5 percent, not less than 0 percent, not greater than 4 percent.

Some factors to keep in mind when setting such parameters:

- Evaluating the impact of the plan provision on the amortization period and funded ratio after the plan provision takes effect, including whether the system will still meet its target date to reach full funding.
- Putting thresholds in place such that an increase can take effect only if the amortization period is below a specified threshold and the funded ratio is above a specified threshold after the benefit increases are factored in.
- Assessing whether the benefit increases are paid for by current active members to avoid passing down benefit costs to future generations.

Surplus Management

If a system is consistently funded at a rate above the ADC, there is a stronger likelihood of the system achieving a high funded ratio. A funding policy, including several in-, should include provisions detailing steps to follow if a system achieves full funding. A surplus management policy should include the following elements:

- Reviewing system risk management policies to evaluate their efficacy.
- Evaluating current assumptions to ensure reasonableness.
- Considering what changes should be made to employer and employee contributions (if any) when the system is in a surplus.
- Working with the sponsor to establish acceptable conditions for possible benefit enhancements, especially permanent ones, and provide accurate estimations for the immediate and long-term costs.⁹

⁹ "Core Elements of a Funding Policy for Governmental Pension and OPEB Plans" *Government Finance Officers Association*, approved March 23, 2023, <https://www.gfoa.org/materials/core-elements-of-a-funding-policy>

Examples:

- **Municipal system.** If the system is overfunded, the surplus will be amortized over an open amortization period of 30 years.
- **Texas.** Below are examples of components from those funding policies. **Statewide system.** If the system is overfunded, all prior bases are erased, and one surplus base would be established. The asset surplus is used to generate a contribution credit for the year that is projected to remain the same over time and keep the funded ratio constant year over year. This practice reduces contribution rate volatility.

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%. ² 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. ³
	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 ≤ 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. ⁴
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. ⁵
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. ⁶
	Houston Firefighters' Relief & Retirement Fund Houston Municipal Employees 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. ⁷

Component	Plan	Description
Risk-sharing	Houston Police Officers' Pension System	
	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. ⁸
	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. ⁹
	Wisconsin State Retirement System	Retirement annuities are adjusted using a formula that factors in investment returns. ¹⁰
	Pennsylvania State Employees ¹ Pennsylvania Public School Employees ¹	The employee contribution rate increases or decreases based on investment plan returns. ¹¹

DRAFT

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 plansystem. 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 often should we review the funding policy?
- How is the plansystem governed? What statutes or ordinances govern plansystem funding?
- What are our funding priorities?

Funding ~~Objectives~~objectives

- ~~Over what time period will we~~What is the target date to achieve 100% percent funding?
- How will we measure progress towards full funding? How will we measure if our funding objectives are being met?

Actuarial ~~Methods~~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% percent 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~~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 for contribution decreases to occur?

When to allow benefit increases

- What conditions must be met to adopt benefit increases or cost-of-living adjustments?
- ~~What conditions must be met for contribution decreases to occur?~~
- What will the impact of the benefit increase be on the amortization period and funded ratio?
- Will the system still meet its target date to achieve full funding?
- Will the resulting amortization period be less than the average remaining future service for current active members?
- Will the resulting funded ratio be above the system's desired threshold?

Contribution distribution between members and city

- Will members contribute appropriately for the level of benefits received?

- Is there a target employer normal cost as percent of pay (total normal cost percent less employee contribution percent)?
- Risk Management Policy 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?
- Surplus management policy**
 - What actions will we take should the system receive funding over the ADC?
 - What actions will we take when the system exceeds 100 percent funding?

¹Brainard, 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>

²South Dakota Retirement System, *SDRS Funding and System Management Policies*, <https://sdrs.sd.gov/docs/SDRSFundingPolicy.pdf>.

³City of Austin Employees' Retirement System Benefits & Services Committee, *City of Austin Employee's Retirement System Board Approved Policy: Funding Policy and Guidelines*, 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>.

⁴*ibid.*

⁵Employees' Retirement Fund of the City of Fort Worth, *Annual Actuarial Valuation*, 19 April 2019, p. 9, <https://fortworthretirementtx-investments.documents-on-demand.com/?l=f419cc743442e5119795001fbc00ed84&d=64e81193956ae911a2cd000c29a59557>.

⁶South Dakota Retirement System, *SDRS Funding and System Management Policies*, <https://sdrs.sd.gov/docs/SDRSFundingPolicy.pdf>.

⁷Retirement Horizons Incorporated, *City of Houston HMEPS Pension Reform Cost Analysis*, 15 March 2017, <https://www.houstontx.gov/pensions/public/documents/rhi-HMEPS.pdf>.

⁸H.B. 2763, 86th Texas Legislature, Regular Session, 2019, <https://capitol.texas.gov/tlodocs/86R/billtext/pdf/HB02763F.pdf#navpanes=0>

⁹Maine Public Employees Retirement System, *Summary: PLD Plan Changes*, www.maineopers.org/Pensions/PLD%202018-Summary.htm.

¹⁰Brainard, 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>.

¹¹The 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>.