National Council on Teacher Retirement

PRESERVING RETIREMENT SECURITY

Actuarial Panel
Funding versus Expense

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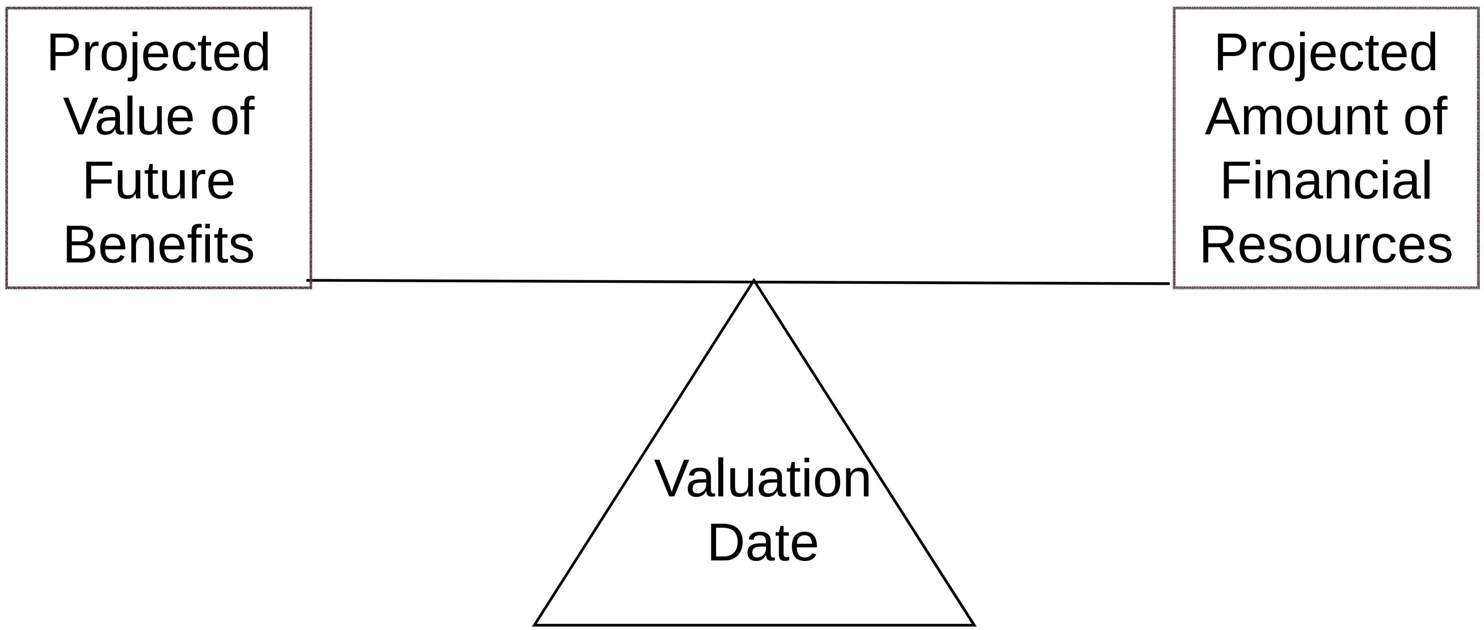
Funding and Accounting Expense

Fundamental relationship between benefits and cost



Over the life of a pension system:

Benefits + Expenses = Contributions + Investment Return

This can also be expressed as:

Contributions = Benefits + Expenses - Investment Return

Funding and Accounting Expense

Determination of employer contributions – Public Sector

- Public sector - GASB provides guidance for both funding and expense
- Funding target based on the Annual Required Contribution (ARC)
  - ARC based on sum of:

    (a) Present Value of current year accrual (normal cost) and

    (b) Amortization of unfunded liability

    - › GASB requires the amortization period to be over a period of not more than 30 years
    - › Choice of assumptions and funding methods to use to determine the normal cost versus the accrued liability and how to amortize the unfunded liability
- Pension expense currently linked to ARC

Funding and Accounting Expense

Determination of employer contributions – Private Sector

- Private sector - IRS provides guidance for minimum funding requirements and FASB/IASB provides guidance for pension expense
- In 2008, Pension Protection Act of 2006 changed how private companies determine the minimum required contribution
  - Minimum required contribution based on sum of:

    (a) Present Value of current year accrual (normal cost) and

    (b) 7-Year Amortization of unfunded liability

    › IRS requires the amortization period to be over a 7 year period; 2010 funding relief allows choice to extend period

    › Unit Credit funding method required

    › Limited choices for discount rate, mortality table and assets

Funding and Accounting Expense

Determination of pension expense – Private Sector

- Method to determine accounting expense unrelated to funding method
  - Net periodic benefit cost based on:
    - (a) Service cost: Present Value of current year accrual +
    - (b) Interest cost: Interest on benefit obligation -
    - (c) Expected return on assets +
    - (d) Amortization of gains and losses, if applicable +
    - (e) Amortization of prior service cost, if applicable
  - Companies allowed to choose gain/loss recognition method
- IASB exposure draft changes method used for determining expected return on assets and gain/loss and prior service cost recognition
- GASB Preliminary Views similar to FASB/IASB

Funding and Accounting Expense

Private Sector Example

		2009 Plan Year	2008 Plan Year
Funding results			
	Effective interest rate	7.98%	6.54%
(A)	Target funding obligation	$173.1	$204.5
(B)	Market value of assets (MV)	$127.1	$190.9
(C)	Adjusted actuarial value of assets (AVA)	$138.5	$194.9
(D)	MV percent funded = (B)/(A)	73%	93%
(E)	AVA percent funded = (C)/(A)	80%	95%
	Funding target phased in percentage	94%	92%
(F)	Target normal cost, including expenses	$2.3	$1.9
(G)	Shortfall amortization	$4.3	$0.0
(H)	**2009 Minimum required contribution = (F) + (G)**	**$6.6**	**$1.9**
Financial statement results			
	Discount rate	7.75%	6.60%
(I)	Projected benefit obligation	$176.7	$197.5
(J)	Market value of assets	$127.1	$190.9
(K)	**Balance sheet liability = (J)-(I)**	**$49.6**	**$6.6**
(L)	**Pension expense (income)**	**$2.5**	**($0.2)**

Funding and Accounting Expense

Financial challenges private sector faced in recent years

- Middle to late 2008, pension asset values began to fall resulting in higher unfunded liabilities
- The pension rules for accounting and funding also changed
  - In 2007, US companies were required to recognize funded status on the balance sheet
  - In 2008, pension funding rules changed
    - "Pension simplification" but many people think otherwise
    - Previously plan amendments recognized over 30 years, assumption changes over 10 years and gains/losses over 5 years now all changes in unfunded amortized over 7 years
  - Benefit restrictions and additional reporting requirements for plans that fall below 80% funded

Funding and Accounting Expense

How did the private sector respond

- Establishing funding strategies focused on funded status rather than just meeting minimum required contribution
- Voluntarily increased contributions to meet required thresholds to avoid additional reporting requirements to both the government and the participants
- Applying methods to reduce risk from their plans, either through plan design or through liability driven investment policies
- Surveys continually note the primary reasons for moving away from defined benefit plans is due to financial statement volatility and cash flow requirement uncertainty

Funding and Accounting Expense

Public sector funding requirements in future

- Who should be responsible for funding oversight?
  - Many stakeholders at-risk:
    - Governments are responsible for balanced budget and generating required revenue to fund expenses
    - Employees want benefit security
    - Taxpayers want low taxes, and comfort that their tax dollars being spent wisely
  - How will rating agencies, bond holders and politicians react?

Funding and Accounting Expense

Public sector funding requirements in future

- If ARC no longer applicable, how will funding targets be set?
  - GASB expects de-linkage between funding and expense
  - Does the de-linkage obscure transparency of the funded status?
  - Will this exacerbate inter-generational inequities?
- Prudent funding policies will be critical and adherence to the policies essential

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