December 19, 2008

Understanding Actuarial Funding Methods

What are actuarial funding methods?

Actuaries use actuarial funding methods to determine how much employers and employees need to contribute to a pension plan today, to pay for tomorrow's pension benefits.

How do they work?

Actuarial funding methods allocate a pension plan's costs over an employee's career. Actuaries refer to the annual and on-going cost of a pension plan as the plan's "normal cost." If everything happens as planned, the contributions to pay these normal costs will accumulate with investment earnings and completely fund an employee's pension by the time of his or her retirement. If normal cost contributions don't accumulate as planned, the pension plan will accumulate a shortfall or excess during an employee's career. Actuaries refer to this as the plan's "unfunded accrued liability."

Are There Different Funding Methods?

Yes, but it's important to know that they all accomplish the same goal of funding future pensions; they just do it differently.

How Do They Differ?

They differ in the amount of the normal cost and the treatment of any unfunded accrued liability.

What Funding Method Do We Currently Use?

Washington's retirement systems for public employees that are open to new members (Plans 2 and 3) use the Aggregate funding method.

This funding method funds all pension plan costs over an employee's expected career. An unfunded accrued liability will not emerge under this method since the Aggregate funding method will increase or decrease the plan's normal cost to address any shortfall/excess over an employee's career.

PO Box 40914
Olympia, Washington, 98504-0914
http://osa.leg.wa.gov

Phone: 360.786.6140
Fax: 360.586.8135
TDD: 800.635.9993

What New Funding Method Was Proposed?

The Governor, in her proposed 2009-11 budget to the Legislature, recommended a switch from the Aggregate to the Projected Unit Credit (or PUC) funding method.

Under PUC an unfunded accrued liability can emerge. When this occurs, the shortfall/excess is broken out from the plan's normal cost and is typically paid over a longer period (similar to a mortgage).

What Happens When Plans Change Funding Methods?

Similar to lengthening or shortening the payment period of a loan, or switching from a fixed rate to an adjustable rate mortgage, the required annual contributions to a pension plan (the financing cost) will change when the funding method changes.

Can Employers and Employees Save Money From a Funding Method Change?

Yes, but only in the short run. Since all funding methods accomplish the same goal and fund the same pension benefits, any short-term reduction in contributions from a funding method change will be followed by higher pension contributions in the long-term. The reverse is also true. Any short-term increase in contributions from a funding method change will be followed by lower contributions in the long-term.

N:\MS\Understanding_Actuarial_Funding_Methods.docx