



## ADVISORY

### **Responsible Management and Design Practices for Defined Benefit Pension Plans (2010) (NEW)**

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

**Background.** State and local governmental defined benefit pension plans are the cornerstone of public employee retirement and require systematic, sound management of their benefits structure, their funding, and their investments. However, certain inappropriate practices can jeopardize the sound management of these plans, undermine their funded positions and ultimately impose burdens on future taxpayers and stakeholders. (For more information, see the GFOA's Best Practice on *Developing a Policy for Retirement Plan Design Options*.)

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that under no circumstance should state and local government plan sponsors engage in pension contribution holidays or make insufficient contributions. When employers skip an actuarially required contribution or make a smaller payment than required, they defer that cost to the future and jeopardize the long-term funding of the plan. When governing bodies arbitrarily reduce contributions to a plan, the resulting systemic underfunding ensures future financial shortfalls and places the burden for that shortfall on future taxpayers. These types of funding decisions compound future funding problems and are, in many instances, a leading cause of funding shortfalls.<sup>1</sup>

The GFOA further recommends that state and local government plan sponsors use great caution if engaging in the following practices:

**1. Spiking of final pensionable compensation.** A pension formula that allows extraordinary income to be included in the base salary on which pensions are based may result in inequitable distribution of benefits and hidden costs, and potentially cause a public perception of impropriety.<sup>2</sup>

**2. Sustainable full-retirement ages.** With increased life expectancy, plan sponsors must reevaluate their normal retirement ages and the availability of early, unreduced retirement options, and make appropriate adjustments to ensure the sustainability of the plan. For example, the normal eligibility age for federal Social Security benefits has already been increased from 65 to 67 and may increase even more to reflect increased longevity. Public employers have begun to adjust their plans' retirement ages upward to reflect known demographic changes. More plan sponsors need to assess the public policy and cost management reasons for making retirement age changes.

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<sup>1</sup> Pension funding is premised on "time value of money" concepts, including the compounding of investment earnings over defined periods of time that begin on the date of the actuarial valuation. Actuarially required contributions are calculated with the expectation that they will be made in the same year that benefits are earned (i.e., in the current year of service). For the plan to meet its obligations without increasing employer contributions, it has to earn compound investment returns over the remaining working lives of employees. For example, if a contribution of \$1 million is not made in a plan with remaining average service lives of 20 years and an assumed earnings rate of 8 percent, then \$4.66 million will not be available to pay benefits in 20 years. Future taxpayers will be burdened by this extraordinary and avoidable cost.

<sup>2</sup> Spiking is defined as an unusual increase in income during the employee's final years of service that increases the employee's pension benefits. Examples include increases in income through unused vacation, sick leave, and overtime.

**3. Retroactive benefits increases.** When pension plan sponsors provide retroactive benefits to active employees, the result is an immediate increase in the existing liabilities of the plan. These benefits, related to past service, have not been funded by prior employer or employee contributions. The presumption that a short-term, market-driven asset surplus makes such benefit enhancements affordable is almost always a critical error that can result in significant underfunding.

**4. Deferred Retirement Option Plans (DROPs).** Many retirement plans implemented DROPs under the assumption that they were cost-neutral. However, experience has shown that costs associated with DROP plans have been consistently higher than anticipated in many jurisdictions. These unexpected costs can be attributed to factors such as poor plan design and unrealistic investment return crediting rates. (See *Deferred Retirement Option Plans*, a GFOA Advisory recommending extreme caution in considering DROP plans.)

**5. Ad hoc cost-of-living allowances (COLA) for existing retirees.** An ad hoc COLA creates an immediate unfunded liability. COLA increases, like retroactive increases for active employees, should not be paid for with temporary surpluses or extraordinary earnings. Additionally, gainsharing and similar arrangements that allocate short-term returns above the assumed rate to retiree benefits will ultimately impair the plan's funding.

**6. Realistic investment assumptions.** The assumed investment rate of return should be the rate that is realistically expected to be achieved over the long term. This rate should be evaluated regularly to ensure it remains realistic. Unrealistically high investment return assumptions are likely to result in a chronically declining funded ratio and higher contributions in the future. Caution should be exercised to ensure the investment return assumption reflects the reasonably expected returns of the plans asset allocation over a reasonable period of time. (For additional information, see the GFOA's *Public Employee Retirement System Investments Best Practice*.)

**7. Non-contributory plans.** Plan designs that include employee contributions ensure that participants appreciate the value of their benefit and bear a proportionate share of the cost of any benefit enhancements.

**8. Prior service credits.** Some pension plans allow employees to purchase service credits. When such credits are calculated at full actuarial cost and reviewed regularly, this practice may be viable, but caution is necessary in the pricing of such options.

Approved by the GFOA's Executive Board, October 15, 2010.