STATE ADMINISTRATION AND VETERANS' AFFAIRS INTERIM COMMITTEE

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PENSION AMORTIZATION POLICY: OPEN, CLOSED, AND LAYERED POLICIES

INTRODUCTION

HJ 8 (2021), assigned to the State Administration and Veterans' Affairs (SAVA) Interim Committee, calls for an interim study of the financial stability of Montana's defined benefit public employee retirement systems and the development of a long-term strategic approach to funding the systems. This briefing paper provides information about the different types of amortization policies and serves as a primer for the panel discussion at the March 24, 2022, SAVA meeting.

TYPES OF AMORTIZATION POLICIES

In pension policy, the amortization period is the amount of time required to pay off a retirement system's unfunded actuarial accrued liabilities (UAAL), calculated by the retirement system's actuary based on projected contributions and investment earnings. The UAAL is the excess of a defined benefit retirement plan's actuarial liabilities at any given point in time over the value of its cash and investments on the same date. There are three amortization policies in relation to pensions – open, closed, and layered. Each policy has advantages and disadvantages regarding the likelihood of paying off the UAAL and the volatility impact on contributions. Amortization periods in the public sector range from 15 to 30 years.

OPEN AMORTIZATION POLICY

- Under an open or "rolling" amortization policy, the unfunded liability resets annually based upon the entire net pension liability. The amortization period remains constant resulting in a consistent percentage of the net liability paid each year.
- In the event there are never any gains or losses in the future, the amortization payment slowly declines, and while the unfunded liability decreases, the plan cannot fully fund because the amortization period resets each year.
- Contribution volatility is minimized in an open amortization policy because the future gains and losses amortize over a new period every year.

CLOSED AMORTIZATION POLICY

- Under a closed amortization policy, the unfunded liability is amortized by a specific date, paying down the liability over each remaining year, fully funding the policy by the close of the period.
- If there are no gains or losses, the amortization period remains the same throughout the set period.
- As the period decreases, the volatility impact on the contribution rate increases as differences in experience and assumptions that occurred during the year amortize over a shorter period. As the period gets shorter, the volatility in contribution rates may become difficult to budget annually.

Layered Amortization Policy

- A layered amortization policy is a hybrid of open and closed policies. The initial unfunded liability amortizes over a closed period, similar to closed policies. Any gains or losses in future years are re-amortized over a new period like an open policy. With each valuation, a new layer is added to the amortization schedule.
- The amortization of the original unfunded liability and gains and losses from prior years remain unchanged, providing the expectation that the plan becomes fully funded over the amortization period if there are no significant gains or losses.
- Contribution volatility is minimized by spreading new gains and losses over new amortization periods each year. Still, volatility can increase as layers drop off and the end of the initial amortization period approaches.

Montana's Amortization Policy

Beginning in 1997, the state of Montana uses an open amortization policy with a 30-year amortization period that recalculates after every actuarial valuation. As of June 30, 2021, eight of Montana's nine defined benefit pension plans amortize in under 30 years.

Article VIII, Section 15 of the Montana Constitution states, "public retirement systems shall be funded on an actuarially sound basis". In statute:

> "actuarially sound basis" means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years. 19-2-409, MCA.

Amortization Periods of Montana's DB Pension Plans (2017-2021)

PLAN NAME	2021	2020	2019	2018	2017
Teachers' Retirement System (TRS)	24 yrs.	29 yrs.	29 yrs.	31 yrs.	22 yrs.
Public Employees' Retirement System (PERS)	28 yrs.	35 yrs.	36 yrs.	38 yrs.	30 yrs.
Highway Patrol Officers' Retirement System (HPORS)	26 yrs.	39 yrs.	42 yrs.	40 yrs.	37 yrs.
Game Wardens' and Peace Officers' Retirement System (GWPORS)	35 yrs.	40 yrs.	53 yrs.	72 yrs.	70 yrs.
Volunteer Firefighters' Compensation Act (VFCA)	1 yr.	4 yrs.	5 yrs.	5 yrs.	6 yrs.
Judges' Retirement System (JRS)	0 yrs.	0 yrs.	0 yrs.	0 yrs.	0 yrs.
Sheriffs' Retirement System (SRS)	18 yrs.	21 yrs.	21 yrs.	21 yrs.	25 yrs.
Municipal Police Officers' Retirement System (MPORS)	15 yrs.	16 yrs.	18 yrs.	20 yrs.	16 yrs.
Firefighters' Unified Retirement System (FURS)	6 yrs.	8 yrs.	9 yrs.	10 yrs.	10 yrs.

SOURCES

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