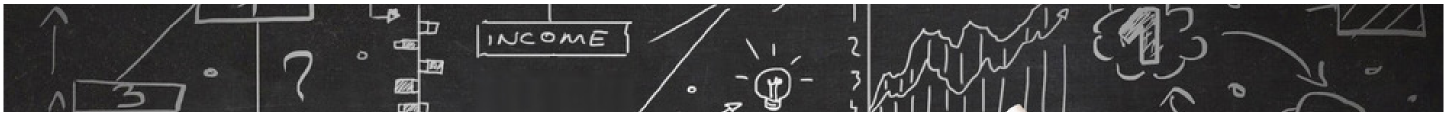


# Important Pension Terms and Definitions

**Normal Cost** is the actuarially determined amount that needs to be contributed to the pension fund today for it to grow over time and be enough to pay out benefits in the future. For the normal cost to be adequate, the actuarial assumptions that go into its calculation must be correct. If any of the assumptions—such as mortality, retention, assumed rate of return, etc.—are overly optimistic or underestimate future experience, they may contribute to unfunded liabilities.

**Unfunded Actuarial Accrued Liability (UAAL)** is the amount of promised benefits that is greater than assets of a pension plan. In most cases it is measured as the amount of actuarially accrued liabilities (AAL) greater than the actuarially valued assets (AVA) of a plan, or simply the AAL minus the AVA. Colloquially, the phrase "unfunded liabilities" is interchangeable with "unfunded actuarially accrued liabilities" (UAAL), "unfunded actuarial liability" (UAL), or "net pension liability" (NPL).

**Unfunded Liability Amortization Payments** are regular contributions made to reduce the unfunded liability. Similar to paying off a loan or bond, they are paid on a set schedule. Pension policymakers determine the time period to pay off certain portions of unfunded liabilities, and the actuary calculates how much should be paid each year. Such payments may be the same each year or tied to a predetermined percentage of payroll.

**Assumed Rate of Return (ARR)** is the assumption about how much contributions into the pension fund will earn as investments. The ARR is a rate chosen by pension policymakers based on what investment advisors think the pension fund's portfolio can earn in the near term and long term. Typically, pension boards choose an ARR close to the "expected" rate of return, which is what advisors think the fund has a 50% chance of earning. The ARR is used to determine how much the employer should contribute to the pension plan on an annual basis to honor the promised retirement benefits for all employees.

**Discount Rate** is used to determine the overall present value of already-promised pension benefits (or liabilities) of a plan. Actuaries count all expected future pension checks that will be paid, then "discount" the value of those back to current dollars. The higher the discount rate, the lower the estimated value of promised benefits; the lower the discount rate, the higher the estimated value of promised benefits.

**Negative Amortization** occurs when payments made toward unfunded liabilities are less than the interest accruing on that same unfunded liability. This is the opposite of what the amortization payments are supposed to do—pay off a loan with regular payments so the total amount owed goes down with each payment. With negative amortization, even though payments go into the plan, the amount of pension debt can still grow.

(For a full list of terms, please visit: https://reason.org/backgrounder/glossary-of-pension-terminology.)

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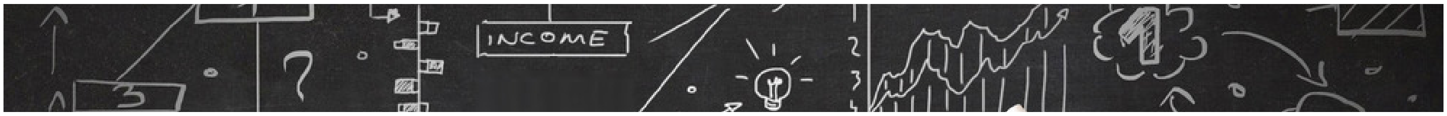
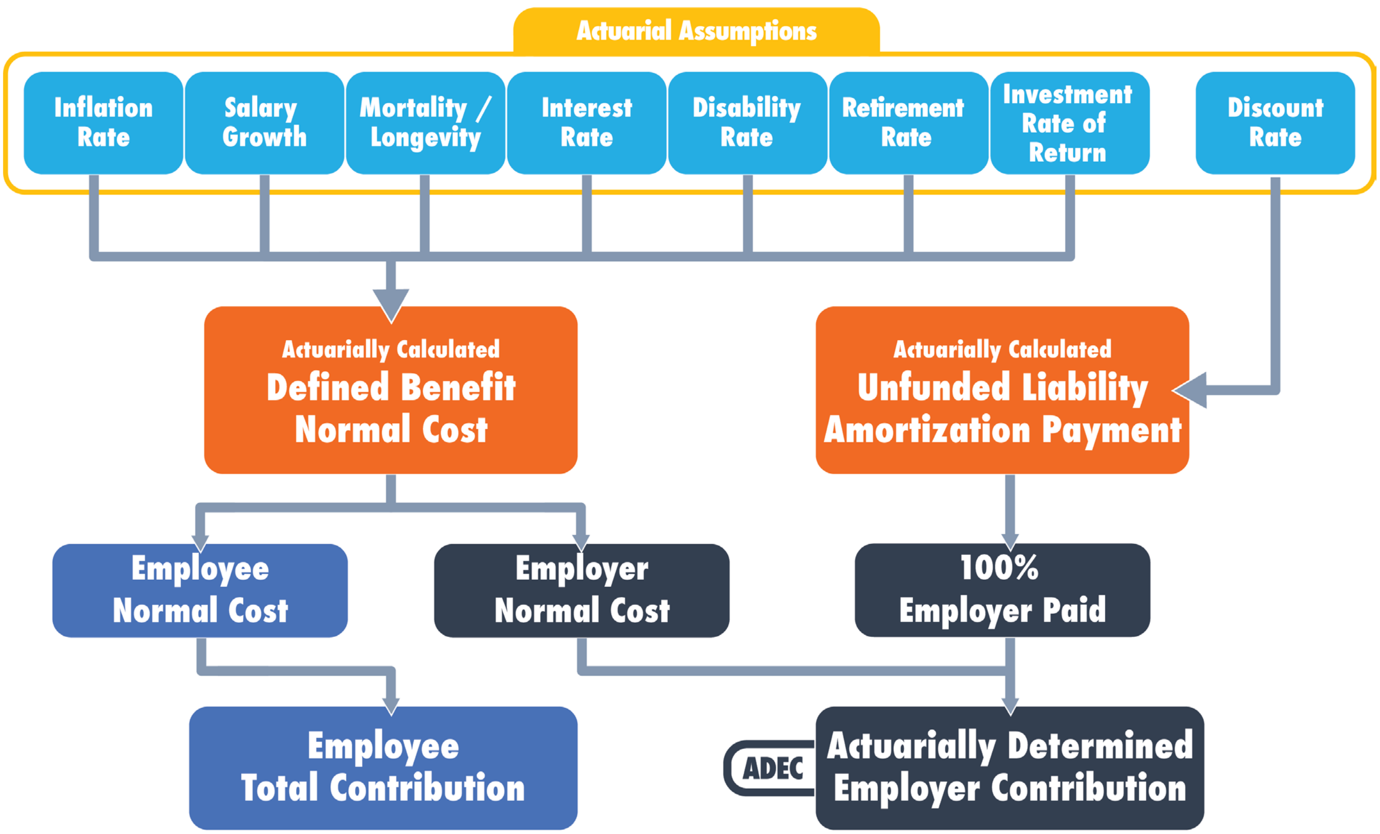



# How Are Defined Benefit Plans Funded?

***Although each pension system has its own unique nuances and structures, there are universally recognized standards and practices shared across all defined benefit plans.***

- Designed to be pre-funded such that when an employee retires, the plan has enough saved to pay for all promised benefits.
- Includes employer-guaranteed specified retirement benefits in perpetuity.
- Benefits are based on the employee's final salary, years of work, and age.
- Has an eligibility age and/or year of service minimum to qualify for retirement.




**Defined Benefit Pension Plans are NOT like Social Security!**

The pre-funded nature of the defined benefit pension system is different from the Social Security system, a "pay-as-you-go" system that is not required to be pre-funded. In the case of Social Security, the government collects tax dollars from the working population to pay for the current benefits of retirees. Rather than maintaining sufficient funds to pay for retiree benefits in a given year, Social Security relies on tomorrow's taxpayers to pay for yesterday's on the condition that the generation behind them will do the same.

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