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May 17, 2011

Committee on Ways and Means
Hearing on Transparency and Funding of State and Local Pension Plans

To: Committee on Ways and Means – Hearing on Transparency and Funding of State and Local Pension Plans

The attached comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Community and are being submitted to the Committee on Ways and Means by the Steering Committee of the CCA Public Plans Community.   However, these comments do not necessarily reflect the views of the CCA Board, the CCA's other members, or any employers of CCA members, and should not be construed as being endorsed by any of the aforementioned parties.

The CCA Public Plans Community (PPC) represents a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems. The following comments reflect a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans.

We are grateful to the Committee on Ways and Means for holding Hearings on Transparency and Funding of State and Local Pension Plans and inviting public-sector actuaries and others to comment on these important issues. We are available to present our comments to the committee if desired. We are also grateful to the Committee on Ways and Means for their hard work in striving to understand these complicated and interconnected issues.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)
Chair of the Public Plans Steering Committee on behalf of the
Public Plans Steering Committee

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Steering Committee of the Conference of Consulting Actuaries Public Plans Community [1]

CCA PPC Comments on PEPTA

We are writing as the Steering Committee of the Conference of Consulting Actuaries (CCA) Public Plans Community to present significant concerns over the Public Employee Pension Transparency Act (PEPTA). The CCA is a professional organization representing credentialed actuaries, including those who work with private- and public-sector retirement plans. The Public Plans Community (PPC) represents a broad cross-section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems. The following comments reflect a substantial consensus among the actuaries who provide valuation and consulting services to public plans.

In February 2011, PEPTA was introduced in the U.S. House of Representatives (H.R. 567) and the U.S. Senate (S. 347). While the intent of these bills is to provide more meaningful measures of state and local government pension plan funding, we do not believe the bills would serve this purpose. On the contrary, key measures required by PEPTA would produce a distorted picture of public pension funding and create substantial confusion about the proper actions needed to address current public pension funding issues.

Our key concern is that PEPTA introduces a new methodology that is inappropriate for measuring the contributions, liabilities, and funded status of public plans. The established approach currently used by public plans focuses on the cost of the benefits to taxpayers, and so measures pension liabilities and costs in a way that includes the effect of both past and future salaries and service. This approach then measures the liabilities using the expected long-term rate of return on plan investments, since those investment returns are a component in determining the net cost of the benefits to taxpayers.

By contrast, the PEPTA approach is what some call a "Market Value of Liability" (MVL) approach. This approach differs from the more established approach in two ways. First, it measures public pension liabilities and funded status based the plan's "current liabilities" using benefits based only on salary and service to date, and ignores the effect of future salary and benefit accruals. Second, it discounts these liabilities using a yield curve based on U.S. Treasury securities, rather than what the investments are actually expected to earn.

In effect, the PEPTA/MVL approach measures the hypothetical price at which the benefits accrued to date might be settled in financial markets, as if there were such a market for public pensions. Of course, public retirement benefits are neither tradable nor transferable, so there is no real market value for them. So while this approach might have theoretical applications either for plan terminations or for purchasing annuities to provide such benefits in insurance markets, it is not an appropriate disclosure measure for ongoing governmental plans. This conclusion is further developed below.

Key Concerns

1) The PEPTA/MVL approach does not reflect the ongoing cost of the pension plan to taxpayers and employees but instead would only reflect a hypothetical market price at which the accrued benefits might be sold. To properly fund

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their plans, decision-makers must know the long-term ongoing contributions which, when combined with current assets and future investment earnings, are sufficient to pay the benefits promised to current and future retirees. These contributions represent the true cost of the plan to taxpayers. This is why actuarial valuations for public plans use well-established actuarial methods that measure liabilities using benefits based on both past and future salary and service. It is also why the liabilities are measured using the expected rate of return on plan assets.

In order to reflect the long-term costs of the ongoing plan, the plan's liabilities and costs must anticipate future conditions related to investment returns, salary increases, and inflation, among other assumptions. This is an appropriate approach for state and local governments which, by their nature, are long-term ongoing entities, and must plan for the actual cost of future payments, net of future investment returns. The PEPTA/MVL approach tries to determine a hypothetical market price of the pension promises made to date. While this might be useful if the plan were terminating, it does not provide relevant information about the ongoing cost for an ongoing plan, and so is a misleading measure of plan liabilities.

2) The PEPTA/MVL approach would not be useful for measuring the plan's funded status. The simplest way to see this is to note that, as indicated in PEPTA itself, the MVL measure is not a basis for determining funding requirements, and so cannot measure how well a plan is meeting its funding requirements. In more specific terms, use of U.S. Treasury bond yields as a discount rate would produce a distorted measure of the plan's funded status. When bond yields are high (e.g., during periods of high inflation expectations), discounting pension liabilities using U.S. Treasury bond yields would understate the liabilities and so make the plan appear better funded than under established long-term valuation methods. However, this does not mean the pension plans are any healthier than shown in their actuarial reports. Similarly, when bond yields are low (e.g., during periods of low inflation expectations), discounting using U.S. Treasury yields would overstate the liabilities. But this does not mean the plan is any worse off than it was when yields were higher. Using U.S. Treasury bond yields also introduces spurious volatility into a pension plan's financial statements that has little to do with the adequacy of plan funding. Consequently, this approach misrepresents the plan's long-term financial health.

3) The PEPTA/MVL approach would not improve the transparency of plan reporting. We recognize the need for meaningful measures with regard to public pension funding. Such measures are essential for determining how much should be contributed to the plan, or whether the plan is making progress toward full funding. However, as we discussed above, the PEPTA/MVL approach would not provide meaningful measures, and in fact would produce misleading results regarding the funded status of public plans. Rather than improving transparency, it would create confusion about the proper actions needed to address the plans' actual funding issues.

It should also be noted that the PEPTA/MVL approach is not, itself, transparent. To understand what the MVL measure really means, one would have to understand the differences between the well-established long-term actuarial approaches and the MVL approach, and how these differences should be interpreted in evaluating the plan's funded status. One would also have to know how changes in U.S. Treasury bond yields have impacted the measures, and be able to separate out the effect of the changes in Treasury yields from the effect of any changes related to the plan itself. In short, the PEPTA/MVL approach does much more to cloud the issues surrounding public pension funding than it does to make them transparent.

Finally one aspect of transparency that PEPTA hopes to address is to provide a consistent measure of liabilities that would be comparable for all plans. While we appreciate the desire for comparability, the PEPTA/MVL approach does not achieve such comparability in any meaningful way. In particular, since the MVL is not related to plan funding, it cannot be used to determine how well funded one plan is compared to another. A better approach is currently being developed by the Governmental Accounting Standards Board (GASB). The GASB has tentatively decided to have all plans report their liabilities based on a single actuarial cost method, which is a widely used level cost method that reflects future salaries and service.

4) The PEPTA/MVL approach focuses on a theoretical "value" of the benefits rather than on the actual cost to the taxpayers. Proponents of the MVL approach argue that it measures the true value of the benefit that the member has accrued. However, what it really measures is the theoretical amount an individual plan member would have to pay, in the absence of the pension plan, to reproduce the benefit by purchasing annuities or other low risk investments in the individual markets. But this ignores the purpose of the pension plan. Through the pension plan, taxpayers can provide retirement security to public employees more efficiently (at a lower actual cost) than by just buying annuities. Consequently, for public plans, the only meaningful measure of plan liabilities is one based on the expected actual cost to the taxpayer, net of investment return, rather than the theoretical value of the benefit to the member. This is also why comparing the MVL to plan assets is a misleading comparison. For public pension plans, plan assets need to be sufficient to pay the cost of the future benefits, net of future investment returns. They do not need to be sufficient to pay the hypothetical costs individual members would have to pay to obtain those same benefits on their own in the financial markets.

Governments provide many benefits to citizens more economically than if the citizenry were to purchase these benefits on their own (defense, highways, schools, etc.). There is no requirement that the government calculate the value of these benefits as if purchased individually outside the government. Similarly, no such measure is necessary or even meaningful for public pensions.

Other Concerns

In addition to our concerns that PEPTA would result in distorted measures of public pension funding, we have other concerns.

5) PEPTA circumvents state and local government authority and undermines the Governmental Accounting Standards Board (GASB) in the setting of accounting and financial reporting standards for state and local governments. The GASB is the nationally recognized rulemaking body for state and local government accounting and financial reporting standards. It establishes and revises its standards through a process of open deliberations and input from all interested parties, and is currently reviewing the accounting and reporting standards for state and local government pensions. Not only has the GASB put considerable effort and research into their proposed changes of public pension accounting standards, but they specifically considered and rejected both the accrued benefit measure and the yield curve discount rate that PEPTA would impose. For the U.S. Congress to ignore the GASB's decisions would substitute a federal reporting requirement in place of standards developed through an informed process of discussion and consultation by the nation's recognized rulemaking body for state and local governments. Moreover, given state and local governments' widespread adherence to the GASB standards, any federal oversight is arguably redundant, and contrary federal oversight (such as PEPTA) would be confusing and misleading.

6) At a time when governments are under enormous fiscal pressure, PEPTA would require unnecessarily higher expenditures on the part of the federal, state, and local governments. To comply with PEPTA, every state and local government would need to have additional actuarial valuations and projections done to conform to the Act's requirements. This amounts to an unfunded mandate imposed on state and local governments to produce measurements that are neither meaningful nor useful. This is particularly problematic for sponsors of cost-sharing multiple employer plans. These are public plans that share pension costs across all participating employers, and consequently have one actuarial valuation done for the plan as a whole and not for individual employers. Also, in order for the federal government to collect and audit the annual reports to ensure they comply with PEPTA's provisions, the U.S. Treasury would have to divert current resources or hire additional employees for this purpose.

Conclusion

Clearly, recent economic conditions have put significant fiscal pressure on state and local governments. Some of this pressure stems from higher pension contributions, mostly due to sharp investment declines in 2008-2009. As a result, many state and local governments are reviewing their pension plan designs to reduce benefit costs. In addition, many organizations such as the GASB, the Actuarial Standards Board, the Conference of Consulting Actuaries, the American Academy of Actuaries, and others are looking for ways to better communicate the risks related to the cost of public pension plans.

However, for this process to be effective, the measures of public plan contributions, liabilities, and funded status must be meaningful. To be meaningful, they have to reflect the actual cost dynamics of the plan, which must relate to the way the plan is funded. Established actuarial approaches used to fund public pension plans reflect the long-term costs to taxpayers of the ongoing pension plans. In contrast, the PEPTA/MVL measures reflect the hypothetical market price of pension liabilities for which there is no functioning market. Rather than providing transparency, the PEPTA/MVL approach would provide a volatile and distorted picture of public pension funding by focusing on the theoretical value of the benefit to the member instead of its cost to the taxpayer. This would create substantial confusion about the proper actions needed to address current funding issues.