

TO: American Academy of Actuaries' Public Interest Committee
FROM: Norman L. Jones, Chief Actuary
RE: Academy Statement on MVL Disclosure by Public Plans
DATE: August 29, 2008

This memorandum responds to the Public Interest Committee's request for comments regarding an Academy statement regarding public plan disclosure of market value liabilities (MVL). I believe an Academy statement supporting such disclosure would **not** be in the public interest for the following reasons:

1. The MVL approach is unlikely to support better decisions related to public plan funding.

If the MVL were used as an additional measure of public plan liabilities, legislators, taxpayers, and members of the press would have difficulty distinguishing the different purposes behind reporting a "market liability" and a "funding liability." Instead of making financial reporting more transparent, the MVL disclosure would likely lead to confusion about the costs and sustainability of the plans. This, in turn, could result in poor policy decisions and potentially lead to the needless abandonment of public pension plans.

This confusion is illustrated in the history of GASB Statement No. 5.¹ Issued in 1986, it required two measures of a public pension plan's liabilities to be disclosed in the plan's financial reports (as well as the financial reports of the plan sponsors). One measure was determined by applying the actuarial method and assumptions used to fund the plan. The other was determined using the same assumptions, but applied the projected unit credit actuarial cost method. This second measure was intended to provide a standardized measure of the plan's liability that could be compared across all public plans.

In 1994, however, GASB eliminated the standardized measure. In explaining the reasons for this change, the GASB noted that the presentation of two pension liabilities created significant confusion among readers of the financial reports. The Board concluded "the understandability and usefulness of financial reports are enhanced when the actuarially determined pension information is calculated ... consistent with the funding methodology."²

2. Level 1 qualifiers of the Academy's Advocacy Position Decision Model are not met.

The Academy's Advocacy Position Decision Model applies to PIC deliberations. According to the model, each of the Level 1 criteria must be answered affirmatively in order for the PIC to recommend a statement to the Board, including:

- Does the statement advocate a specific position on behalf of the public?
- Is it "actuarial" (in concept and/or content, applying a broad definition)?
- Does it relate to the need of an identifiable public?

¹ GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, November 1986.

² GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, November 1994, paragraph 131.

However:

- **The position advocated by the statement is not specific.** While a statement “supporting disclosure of the MVL for public plans” appears specific, it contains significant ambiguities. Does “support disclosure” mean to allow or encourage disclosure? Such disclosures are already allowed and left to the actuary’s professional judgment. Does it mean to require disclosure? Most people believe the Academy’s statement would be tantamount to a requirement. Other ambiguities include: What “risk-free” rate should be used in measuring the MVL? Should it also be used to calculate contributions? If these ambiguities are not addressed before issuing the statement, the statement could be taken as support for any of these fundamentally different approaches.
- **Disclosure is an accounting issue rather than an actuarial issue.** While measuring public pension liabilities is an actuarial issue, “disclosure” is an accounting issue. It falls under the authority of the Governmental Accounting Standards Board, which is currently in the process of deliberating accounting and disclosure standards for public plans. For the Academy to publically support a specific disclosure standard currently under deliberation by the GASB would be equivalent to the GASB publicly supporting a specific actuarial approach under deliberation by the ASB. This could be seen as an effort to undermine the GASB’s authority and tarnish the Academy’s reputation.
- **No public need has been identified.** According to the U.S. Government Accountability Office, pension plans covering the vast majority of public employees are “reasonably well funded.”³ Moreover, as was demonstrated at the joint Academy/Society Roundtable on this topic, most of the people and organizations directly affected by such a statement oppose it, including: state and local government officials, public plan administrators, public employees, and state pension review boards. Finally, there has been no public call for such a statement from other interested organizations, including the GASB.

3. The Academy’s endorsement of MVL disclosure would have the practical equivalence of an ASOP. The ASB, not the Academy, is the proper place to consider this issue.

For all intents and purposes, an Academy statement supporting MVL disclosure by public plans would carry the weight of an actuarial standard of practice. This would occur without due deliberation by the Actuarial Standards Board.

4. The MVL does not reflect the underlying dynamics of public pension plans.

The unit credit actuarial cost method applied by the MVL does not incorporate projected salary and service after the valuation date in its measure of the plan’s liability. However, for the vast majority of public pension plans, benefits are based on participants’ final average earnings and years of service. A valuation approach that ignores fundamental characteristics of the retirement benefit will not reflect the underlying dynamics of the plan and will not provide an accurate or useful measure of the plan’s liabilities and related contributions.

In addition, discounting pension cash flows using bond yields ties the measurement of plan liabilities to changes in the supply and demand for bonds, which are unrelated to benefits promised by the plan. Consequently, even small changes in the discount rate could result in large changes to reported plan liabilities, even though there were no changes in plan benefits.

³ U.S. Government Accountability Office, *Current Funded Status of Pension and Health Benefits*, January 2008.

5. The MVL would likely allocate pension costs inequitably across current and future taxpayers.

MVL proponents argue that conventional approaches for funding public pension plans result in government (and therefore taxpayer) contributions that are lower than necessary to fund the plan. Consequently, future taxpayers will likely pay higher contributions to make up the difference, violating the principle of intergenerational equity.

However, if the MVL approach were used to determine plan contributions, the resulting contribution rates would be significantly higher than those determined under conventional actuarial methods. Consequently, current taxpayers would pay significantly more to fund the plan than under conventional approaches. Moreover, if these contributions were invested in a diversified portfolio that earns significantly higher returns than the bond discount rate, the plan would become fully funded more rapidly than under current funding schedules. Therefore, at some point, future taxpayers would likely pay less than current taxpayers. This too would violate intergenerational equity.

Additionally, suddenly higher contribution rates would not necessarily motivate governments to make the additional contributions. If the contributions were seen as artificially higher than the amount needed to fund the plan, there would be a disincentive to contribute the full amount.