

RE: The Public Employee Pension Transparency Act
FROM: Paul Zorn
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On December 2, 2010, the Public Employee Pension Transparency Act (H.R. 6484) was introduced in the U.S. House of Representatives by Reps. Devin Nunes (R-CA), Paul Ryan (R-WI) and Darrel Issa (R-CA). If passed, it would require sponsors of State and local government employee pension plans to annually report specific financial information to the Secretary of the U.S. Treasury. Governments failing to report this information would lose their ability to issue tax-exempt bonds until they comply with the reporting requirements. However, the legislation also states that it does not alter the existing funding standards for State and local governments or require Federal funding standards for such plans.

In addition, the proposed legislation would prohibit the Federal government from accepting any current or future obligations of State and local government pension plans or take action to diminish their shortfalls. This extends to the U.S. Federal Reserve, which would be prohibited from providing loans to State and local government pension plans, purchasing their assets, or otherwise diminishing their obligations. Although the legislation was not voted on in 2010, it is expected to be reintroduced in 2011.

Annual Reporting Requirements

Specifically, the legislation would require a plan sponsor of a State or local government pension plan to file an annual report with the Secretary for plan years beginning on or after January 1, 2011. The term "plan sponsor" is defined as the "State, political subdivision of a State, or agency or instrumentality of a State which establishes or maintains the plan." The annual report would have to be filed no later than 210 days after the end of the plan year (or as otherwise determined by the Secretary). The information would be posted to a searchable public website maintained by the U.S. Treasury Department. The items to be reported would include:

- A. **Schedule of funding status**, including the "current liability" of the plan, amount of plan assets, net unfunded liability, and plan's funding percentage. "Current liability" is defined as "the present value of all benefits accrued or earned under the plan as of the end of the plan year."
- B. **Schedule of contributions** by the plan sponsor for the plan year, indicating contributions "which are or are not taken into account" in the schedule of funding status (see item A).
- C. **Alternative projections** related to the annual contributions, fair market value of assets, current liability, and plan funding status for each of the next 20 plan years. This would also include a statement of assumptions and methods used in the projections and those related to the plan's funding policy, benefit changes, future workforce projections, and future plan returns. The Secretary would issue regulations to achieve comparability across plans regarding the assumptions and methods used in the projections.
- D. **Statement of actuarial assumptions**, including the assumed rate of return on invested plan assets for the plan year, and other assumptions as determined by the Secretary.
- E. **Statement of plan participants**, including the number of active, retired, and vested deferred members.
- F. **Statement of the plan investment returns**, including the actual rate of return for the plan year and 5 preceding plan years.

- G. **Statement of the degree and manner in which the plan sponsor expects to eliminate any unfunded current liability** as well as the extent to which the plan sponsor has followed the plan's funding policy for the 5 preceding plan years.
- H. **Statement of outstanding pension obligation bonds**, including the total amount outstanding.

The legislation's definition of "current liability" would require the liabilities (and related measures of funded status and contributions) disclosed in the annual report to be based on benefits "accrued or earned" to date, thereby excluding benefits based on future service. However, most State and local government retirement plans measure pension liabilities based on accrued and future service. Generally, this is done to calculate employer contributions that remain a level percentage of payroll over time, to the extent possible. Consequently, the proposed legislation would require measures of pension liabilities and contributions that are different from those used to fund the plan (and also different from the measures used for accounting and financial reporting purposes).

Supplementary Reporting Requirements

Supplementary reports would be required if the annual report does not measure assets at fair market value or if liabilities are not discounted using U.S. Treasury bond yields. This could result in yet another set of measures related to plan liabilities, funding, and contributions that are different from those mentioned above.

The supplementary reports would remeasure reported items in A, C, F, and G above, using assets at fair market value and liabilities discounted using the "U.S. Treasury Obligation Yield Curve Rate." This yield curve rate would be developed by the Secretary and would consist of three rates, based on U.S. Treasury bond yields of different maturities: (1) over the next 5 years; (2) between 6 and 20 years; and (3) over 20 years. The rates would be determined on a monthly basis and reflect average monthly yields over the preceding 24 month period. Based on selected U.S. Treasury bond yields averaged over the 24-month period ending December 2010, these rates would be about 2.1%, 4.1%, and 4.2%, respectively. Currently, many public plans use an 8% discount rate based on their long-term expected investment returns.

Reasons Given for Change

Many of the reasons given in the legislation for the change emphasize the importance of State and local government pension plans with respect to national commerce. The legislation acknowledges that State and local government pension investments "have a substantial impact on the national economy, affect capital formation, regional growth and decline, the national markets for insurance, and the markets for securities...."

However, the legislation also asserts that State and local government pension plans "are becoming a large financial burden on certain State and local governments and have already resulted in tax increases and the reduction of services." To support this assertion, the legislation quotes an unnamed study published in the *Journal of Economic Perspectives* claiming that the "present value of the already-promised pension liabilities of the 50 states amount to \$5.17 trillion and that these pension are unfunded by \$3.23 trillion." However, it fails to mention other studies that indicate State and local government pension plans are better funded than reported in the legislation.¹ Moreover, the legislation fails to acknowledge the current deliberations and tentative

¹ For example, see: Keith Brainard, *Public Fund Survey Summary of Findings for FY 2009*, National Association of State Retirement Administrators and National Council on Teacher Retirement, November 2010; and U.S Government Accountability Office, *State and Local Government Retiree Benefits, Current Funded Status of Pension and Health Benefits* (GAO-08-223), 2008.

conclusions of the Governmental Accounting Standards Board (GASB) regarding appropriate accounting and financial reporting standards for governmental pensions.

Meaningful Disclosure

The legislation also asserts that there is a “lack of meaningful disclosure” regarding State and local government employee pension assets and liabilities. This raises the fundamental question of what constitutes meaningful disclosure of a public pension plan’s funding status. Meaningful disclosure is clearly important, because it is the basis for knowing how much to contribute to the plans, what funding progress has been made, and whether or not adequate contributions are being made by the plan sponsors.

Although the legislation does not require State and local governments to change the way they currently fund their pension plans, it does change the way that the plan’s funded status would be measured when reported to the U.S. Treasury Department. Under the legislation’s supplemental reporting requirements, public pension plan liabilities would be measured using benefits based only on service to date and discounted using U.S. Treasury bond yields.

The conventional actuarial approach for most on-going public plans measures pension liabilities using benefits based on current and future service, and discounts the liabilities using the expected long-term rate of return on plan investments. This approach is intended to calculate public pension contributions that remain a level percentage of payroll over time, to the extent possible. The problems with requiring disclosure on the proposed basis are that: (1) it will likely provide a distorted picture of State and local government pension funding; (2) it ignores the deliberations currently underway by the GASB; and (3) it may lead to further regulations requiring funding on the same basis.

Actuarial Methods and Public Pension Funding

The extent to which the proposed legislation’s required disclosures could provide a distorted picture of public pension funding is illustrated by a Gabriel, Roeder, Smith & Company (GRS) study done for the Society of Actuaries’ 2009 Public Pension Finance Symposium.² The study compared the pension liabilities and contributions resulting from the conventional actuarial approach used by State and local pension plans with those resulting from the “market value of liability” (MVL) approach. The MVL approach is very similar to the proposed legislation’s approach, since both are based on benefits accrued to date and a “risk free” discount rate (e.g., based on U.S. Treasury bond yields). The comparison was made by applying these approaches to a modeled statewide public pension plan, based on historical demographic, economic, and investment data over the period from 1978 to 2008.

The GRS study illustrates the extent to which conventional and MVL discount rates would have varied over the past 30 years. Discount rates are important since they play a key role in measuring the plan’s liabilities and related contributions. Chart 1 on the next page shows that the conventional discount rate based on long-term expected investment returns remained fairly stable over the study period (rising from 7.0% in 1978 to 8.0% in 1986 and to 8.5% in 1992). By contrast, the MVL discount rate based on 30-year U.S. Treasury bond yields fluctuated widely, increasing to almost 14% in 1982 and 1984 (periods of high inflation) and falling to almost 4% in 2003 and 2005 (periods of low inflation).

² Norman L. Jones, Brian B. Murphy, and Paul Zorn, “Actuarial Methods and Public Pension Funding Obligations: An Empirical Study,” published on the Society of Actuaries website.

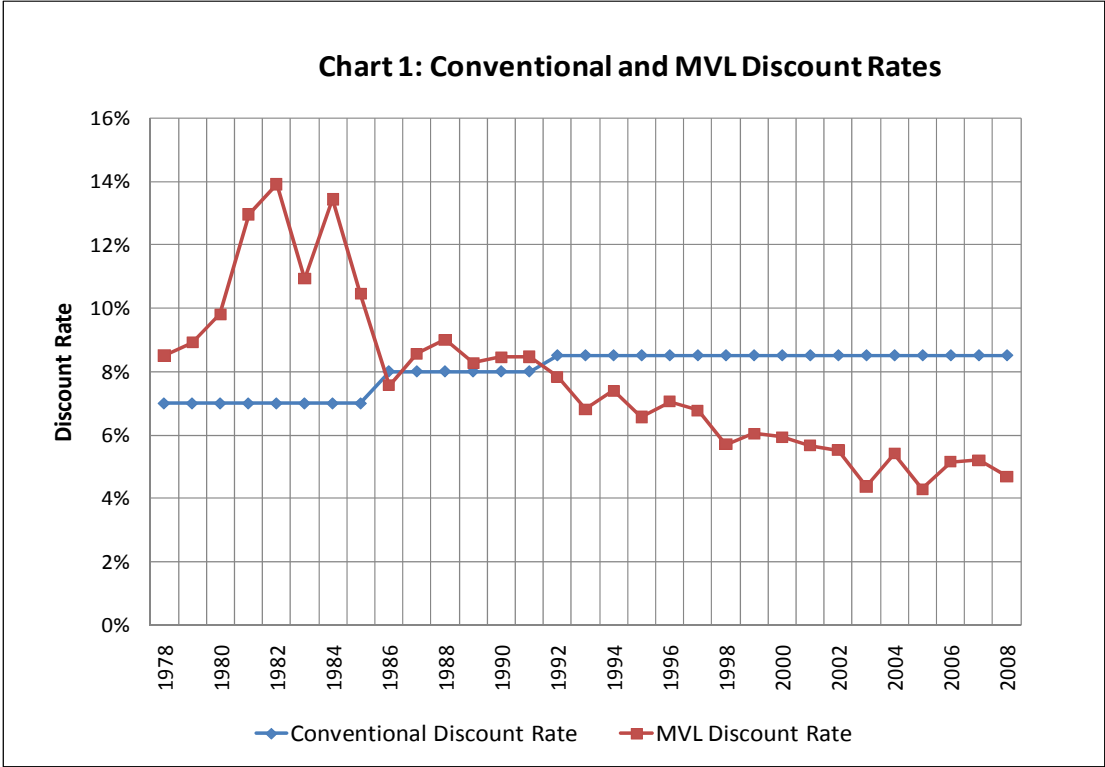
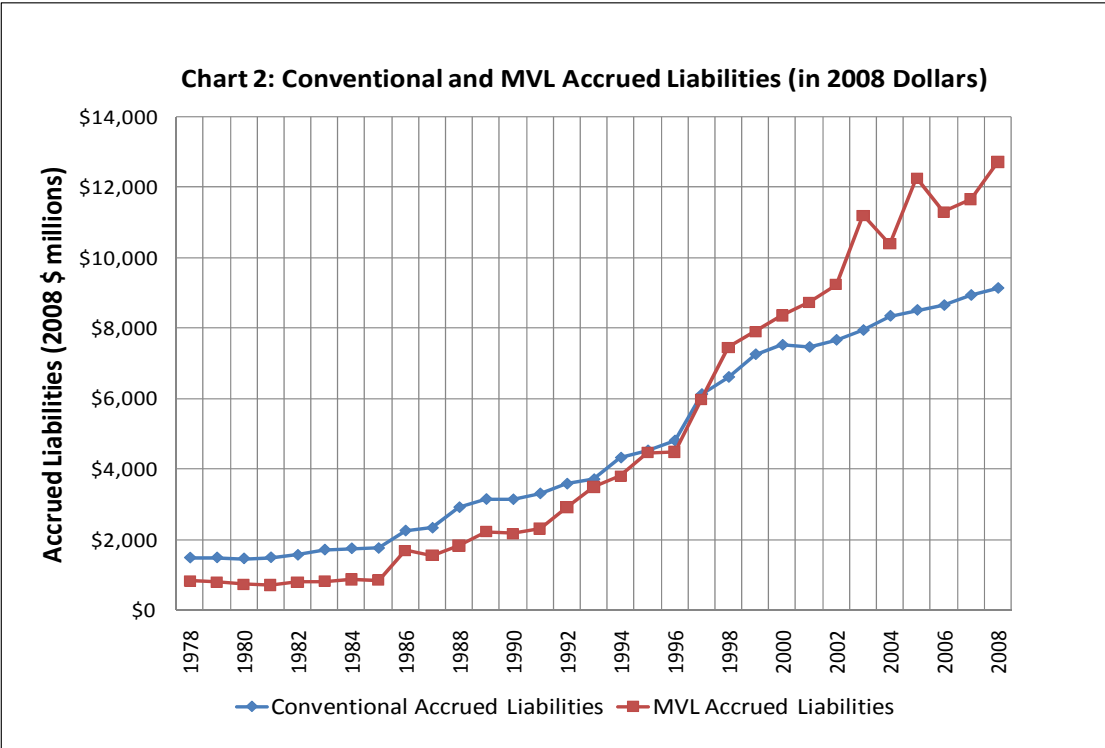


Chart 2 shows the impact of the discount rates on the measures of accrued liability under the conventional and MVL approaches over the study period. Note that for the first half of the study period, the MVL liability is substantially less than the liability under the conventional approach.



The accrued liabilities in Chart 2 are expressed in constant 2008 dollars to better illustrate the relative relationship between the conventional liability and the MVL liability.

Some proponents of the MVL approach claim that the conventional approach systematically understates the accrued liabilities of public pension plans. If so, one would expect the accrued liabilities under the MVL approach to be consistently higher than under the conventional approach throughout the study period. However, this was not the case for the first half of the study period. Moreover, from 1978 to 1985, the MVL liabilities were only about half of the conventional liabilities. In addition, the increases in MLV liabilities by more than \$1.5 billion in 2003, 2005, and 2008 are due largely to changes in U.S. Treasury bond yields, and not to changes in plan benefits.

Chart 2 illustrates the distorted picture of pension liabilities that could result from the proposed legislation's required disclosures. For the purpose of determining the contributions necessary to fund on-going plans, actuarial principles require that the methods and assumptions reflect the dynamics of the plan.³ However, using a discount rate based on U.S. Treasury bonds would result in artificially low liabilities and contributions in times of high inflation, and artificially high liabilities and contributions in times of low inflation, even in the absence of benefit changes. Rather than reflecting the underlying dynamics of the plan, the approach required by the proposed legislation would reflect the dynamics of U.S. Treasury bond yields.

Moreover, to comply with the proposed legislation, governments that sponsor pension plans would have to pay for one and possibly two additional actuarial valuations each year. This would result in additional costs that, overall, could be in the tens of millions of dollars annually. However, without such valuations, the proposed legislation would not allow participating governments to issue tax-exempt debt.

This could be a particular problem for State and local governments that participate in cost-sharing multiple-employer plans. Unlike plans that are established by a single employer, who is entirely responsible for the costs associated with the benefits, cost-sharing multiple-employer plans share benefit costs and risks among all participating employers. Contributions are determined through a single actuarial valuation, and all employers' costs are allocated to the employers on a proportional basis. However, the proposed legislation is unclear regarding employers in cost-sharing plans. Would separate stand-alone valuations for individual employers be required or would a single report by the plan as a whole be sufficient? If separate valuations were required, this would add significantly to the participating employers' administrative costs.

Conclusions

Rather than provide meaningful measures, it is likely that the proposed legislation would provide a distorted picture of State and local government pension funding and create confusion among decision-makers. This, in turn, could lead to the abandonment of public pension plans, potentially contributing to further declines in the national economy, capital formation, and regional economic growth.

The GRS study is available on the Society of Actuaries website at:
<http://www.soa.org/library/monographs/retirement-systems/public-pension-finance/2010/june/mono-2010-mrs10-jones.pdf>

³ Actuarial Standard of Practice No. 4, § 3.11.b. states: "The attribution of normal costs should bear a reasonable relationship to some element of the plan's benefit formula or the participants' compensation for service."