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Author's Response to Comments by David T. Kausch

By Robert C. North Jr.

I want to thank Dr. David T. Kausch for taking the time to review and comment on my paper on "Presenting Market Value Liabilities for Public Employee Retirement Systems."

Before focusing on specific comments, it is my interpretation that several of the comments made by Dr. Kausch appear to be ones that address issues of politics and/or implementation. While I also inserted some of these into the paper, my primary intent was to provide a real case study of the what, how and why of presenting Market Values of Liabilities (MVLs) for Public Employee Retirement Systems (PERS). I was trying to make a case for the usefulness of making these disclosures and not trying to spend too much time on reacting to the dislike that most public plan actuaries, Trustees and Plan Sponsors have for this information. I have long felt that presenting MVLs and related disclosures is valuable, can lead to a better understanding of the economics of pension plans and should not be hidden away or ignored just because the results might be unpopular.

With respect to specifics, Dr. Kausch presents his comments in three sections and my responses are set forth hereafter in a similar manner.

First, following are responses to some comments under the Actuarial Communication Issues section of his discussion:

1. Dr. Kausch notes that MVL information is often used by those interested in harming defined benefit pension plans and that "actuaries must take great care that actuarial services are not used to mislead." I agree with this quoted concern but I also believe that actuaries who present MVL and explanations about it, in a manner similar to that shown in the Comprehensive Annual Financial Reports (CAFRs) of the New York City Retirement Systems (NYCRS), have met their professional standards. Possibly more importantly, by presenting MVL information themselves, actuaries increase their own opportunities to demonstrate their economic knowledge from which they can then better defend the benefits of defined benefit plans. In addition, I believe these actuaries can move the actuarial profession closer to being treated as a credible discussant in the ongoing, larger academic/economic/political debate around the future of defined benefit plans for public employees. Presenting MVL information may exceed the limited requirements for an actuary to serve an individual client but if actuaries do provide and discuss MVL they may then be given more credibility and be treated as having more expertise on the economics of PERS. This expansion of what is considered the range of professional expertise of actuaries can be nothing but a benefit for the actuarial profession, its clients, other stakeholders and the public at large.

2. Dr. Kausch also observes the value of multiple disclosures and their uses. He also raises the question of what is "true cost." First, I would observe that the term "true cost" needs to be appropriately defined. That said, it should be acknowledged that much actuarial terminology is at odds with that typically used by most financial experts. It should also be noted that whatever "true cost" might be defined to be by most financial experts, it is unlikely to be an actuarial definition and more likely something founded on the ideas of economics. I encourage all pension actuaries to consider the wider financial world and its terminology and to understand that the terminology used by actuaries is unique and, except where codified in statute, unseen anywhere else.
3. Dr. Kausch also asks whether there are any examples of the information presented in the NYCRS CAFRs being used elsewhere. I would point to the paper by Dr. Jeremy Gold and Mr. Gordon Latter titled "The Case for Marking Public Plan Liabilities to Market". Unlike my paper that is more of a case study, their paper is a thorough and academically valuable discussion of the reasons for utilizing MVL for PERS. As part of their analyses, Dr. Gold and Mr. Latter did utilize some of the NYCRS information to evaluate their own estimating techniques and to illustrate how to apply that information in various ways. Beyond that, I am not aware of academics or others utilizing directly any Market Value Funded Ratio (MVFR) or related information reported by the NYCRS. Alas, possibly because other actuaries do not report MVL information, academics choose to develop their own estimates, estimates that can never be as accurate or as well-explained as those that actuaries could provide.
4. Dr. Kausch further notes that my paper focuses mostly on the MVFR rather than on the underlying Market Value of Assets (MVA) and MVL. I have to confess that this was done intentionally in order to limit the tables and space requirements for the paper. This was probably a bad decision as seeing the MVA, Actuarial Asset Value (AAV), Governmental Accounting Standards Board (GASB) Actuarial Accrued Liability (AAL), Entry Age AAL (EAAL), Projected Benefit Obligation (PBO), Accrued Benefit Obligation (ABO) and MVABO values together, along with information on the economic and other assumptions, provides all kinds of useful information as well. I encourage readers to go to the June 30, 2014 New York City Police Pension Fund (POLICE) (or any other NYCRS) CAFR in order to see the whole of what was presented and how it was discussed.

Second, following are responses to some comments under the Volatility of the MVFR section of his discussion:

5. Dr. Kausch questions whether the volatility of the MVFR (i.e., the MVA/MVABO ratio) might be less than other reported funded ratios. It is my general contention that the MVFR should tend to be less volatile than the MVA/ABO ratios (and, likely, other MVA funded ratios based on AAL developed using a fixed discount rate) since a portion of the assets (i.e., longer-duration bonds) have characteristics similar to those of the benefits being paid. While I believe my measurement of this for POLICE from 1999 to 2009 is still true, I confess it is not compelling. Upon

further reflection, the bonds held by POLICE during that period, while having greater average duration than that typical of most PERS, still had an average duration much less than the duration of the benefit payments. They were also only a modest portion of the asset allocation. Hence, the offsetting impact of having these bonds versus the benefit payments was not dramatic. As noted by Dr. Kausch, a full Liability-Driven Investment (LDI) policy would produce significantly dampened volatility of the MVFR. While I am unaware of any PERS currently using a full LDI strategy, to the extent a PERS was to lengthen the duration of its bond portfolio and to increase its exposure to such bonds, then the volatility of the MVFR should be clearly less than the volatility of the MVA/ABO ratio. I thank Dr. Kausch for allowing for this clarification of my intended comments.

6. Note: It was never my intention to suggest that the MVFR would be less volatile than AAV/ABO or any other ratios based on AAV since the volatility of assets tends to be greater than the volatility of the liabilities and most asset smoothing techniques greatly dampen the impact of asset changes and/or the definition of the funded ratio itself limits volatility (e.g., funded ratio under the Frozen Initial Liability (FIL) Actuarial Cost Method (ACM)).
7. Dr. Kausch also notes that while risk is often focused on the downside, MVFR can be volatile to the upside and he questions whether this adds helpful information versus smoothed actuarial values for PERS with long-term investment policies. There is no question that MVFR is volatile to both the upside and the downside when a PERS chooses to mismatch the characteristics of its assets and liabilities. It is this volatility of the MVFR that highlights the mismatch and should encourage Trustees and others to focus more time and thought on the overall economics of the investment policies employed and the implications that reducing (or maintaining) such volatility could have on benefit and funding policies.
8. Dr. Kausch also raises questions about actuarial expertise in the area of investments with issues such as whether there would be enough long-duration bonds to implement an LDI strategy and whether actuaries may be treading into fiduciary and other areas where they should not go. While many actuaries may not be and/or may not wish to be considered experts on all financial aspects of PERS, I believe most pension actuaries are able to and should engage widely in discussions of the individual and combined economic implications of benefit, funding and investment policies on a PERS.

Finally, following are responses to some comments under the Technical Considerations section of his discussion:

9. Dr. Kausch questions my equating of MVL with Solvency Liability for the NYCRS. I am willing to stand by this contention as long as the City of New York continues to appear to be an economically viable governmental unit, the City remains committed to the NYCRS and New York State Constitution Article 5, Section 7 remains in effect. Given a choice between reporting an MVL and a Solvency Liability, I confess that I would prefer for every PERS to report a Solvency Liability for no other reason than the Solvency Liability is the commitment

and using Solvency Liability instead of MVL does remove the debate over the issue of Plan Sponsor support and PERS viability. I consider it a great shame that places such as Detroit have had to declare bankruptcy and, in the process, have the State Constitutional protections overridden, benefits cut and, effectively, commitments reneged upon. I believe our profession is doing a disservice to our clients, usually the Trustees of PERS, and to other stakeholders by not presenting Solvency Liabilities and discussing their implications, especially the asset/liability mismatch risks. This is particularly so in any situations where the long-term viability of the Plan Sponsor could be suspect.

I want again to thank Dr. Kausch for reviewing and commenting of my paper. I appreciate his observations and the opportunity to respond and expand upon the ideas I have set forth.

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